FINANCIAL SECTOR DEVELOPMENT PROJECT (FSDP II)

MOBILIZING EQUITY CAPITAL IN THE PALESTINIAN TERRITORIES

FINAL REPORT

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Executive Summary

USAID has outlined a program of technical assistance initiatives intended to mobilize the flow of equity capital to the private sector of the Palestinian Territories. To determine whether the program warrants implementation, USAID commissioned a five-person Team:

- To validate its assumptions,
- To ensure its workability through a detailed design, and
- To determine whether its funding would be money well spent.

USAID's program objectives were selected to complement other donors' financial sector activities, particularly the IMF's efforts in banking and financial sector reform and the World Bank's initiatives involving the flow of capital. The Design Team commissioned for the assessment of this program consisted of a program economist/team leader, and specialists in securities market regulation, pension and insurance reform, accounting and auditing standards, and the related matter of professional ethics. The economist was assigned the task of assessing the potential overall economic impact of a successfully implemented program.

The Design Team is satisfied that USAID's program does warrant implementation. The program is feasible, will advance the development of the Palestinian capital market, and the expenditures and staff time devoted to its support will represent money well spent. Still, it is important to note that no program of technical assistance can succeed unless and until there is political stability in the region.

The key rationale for USAID's programmatic focus is that, by strengthening the domestic capital market, domestic assets would be made more attractive in yield and risk. As a consequence, an increased portion of the domestic savings flow, and the stock of wealth held abroad by Palestinians, is likely to be directed to domestic capital formation. An indirect but clear benefit of this increased capital market efficiency would be to make many domestic capital investments, public as well as private, financially feasible. Still, the focus on domestic financial institutions can only be a sensible policy strategy if a substantial flow of saving exits. The Design Team is satisfied that it does, as

evidenced by various measures of bank deposit flows and survey estimates of household savings in the Palestinian Territories.

Deposits in banks in the West Bank and Gaza totaled $1.7 billion at the end of last year, having doubled in 1995 and grown by half again in 1996, despite the negative impact of closures on incomes. Survey estimates of household earnings and expenditures in the West Bank and Gaza by the United Nations, Office of Special Coordinator in the Occupied Territories (UNSCO), a United Nations agency, showed that in the West Bank alone, saving exceeded $1 billion in 1996. Yet, according to the Palestinian Monetary Authority, banks in the West Bank and Gaza extend a paltry portion of their deposit base in domestic credit, primarily on a short-term basis, holding most of their assets in the form of foreign government securities or correspondent bank deposits in Jordan and Israel. It is not only banks that favor foreign assets over domestic investment: According to the Ministry of Finance, $250 million of the reserves of the Gaza Pension Fund are currently held in a Swiss bank account, and it has been estimated that as much as $10 billion in assets in the Middle East are held by residents of the Palestinian Territories.

The Design Team observed that construction activity in the West Bank and Gaza (WBG) is the one domestic investment reflecting the Palestinian savings potential, being the only form of investment in WBG which has increased in real terms throughout the 1990s. Construction has increased more than 50 percent during 1992-95, and is up 39 percent over 1988. It now comprises about one-fourth of GDP, compared with an average of 17 percent during 1988-92.

Consequently, both the existence of a substantial savings pool in the Palestinian Territories and the willingness of Palestinians to invest in secure domestic capital assets have been validated. USAID's program would help direct this saving to domestic equity capital by providing technical assistance for the regulation of the securities market, the reform of pensions and insurance, and the establishment of accounting and auditing standards.

During one month of field work, the Design Team interviewed more than 20 officials of the Palestinian Authority, and more than 60 professionals from 36 institutions in the private sector and from five international donor agencies. Combining the insights from these interviews, their own professional experience, and background readings, the Team has constructed recommendations to develop an operational set of activities to implement USAID's program with explicit performance measures, schedules and policy benchmarks. In the course of constructing these recommendations, the counterpart relationships through which they would be effected have been carefully specified and verified. It is also worth noting that the counterparts in the Ministries of Finance, Economy & Trade, and Justice appear enthusiastic in their support of the proposed initiatives.

Securities Market Regulation. In order to establish a credible and liquid securities market in the Palestinian Territories, it is essential to develop an efficient and effective securities market regulatory system within the statutory framework of a Securities Law. At present there is neither a Securities Law nor any form of public securities market regulation in the Palestinian Territories, notwithstanding the operation of a stock exchange in Nablus. Thus, the passage of such a Securities Law and the development of an effective securities regulatory system with its statutory framework are the central issues to be addressed in this sector. The law should be administered and enforced by an independent Securities Regulatory body including representatives from the private commercial sector. Similarly, the development of a unified and modern Company Law is necessary to improve the present inadequate commercial legal infrastructure. The development of these two Laws should proceed in parallel.

Pension and Insurance Reform. Two major sources of long-term capital formation in developed economies are the investment reserves of funded pension plans and the reserves of insurance companies. In order to develop these sources, it is necessary to introduce statutory and regulatory controls that will ensure prudent management of funds. One payoff from this regulatory structure will be the transfer of funds covering the pensions of Palestinian workers in Israel; these funds are currently under the control of the Government of Israel, and they will not be remitted until an acceptable legal and regulatory framework to conserve and administer them has been established and implemented. This potential transfer and the related tension over the lack of payment to the PA by Israel make the implementation of this regulatory structure a priority for pension design.

Once the proper legal and regulatory structures are in place, there will be three potential sources of funds to provide capital for investment:

- ♦ Provident funds for the employees of the multinational NGOs and a few of the larger private sector employers;
- ♦ Pension deductions currently being withheld by the Government of Israel from Palestinian workers employed in Israel;

- Employment termination benefits.

The insurance sector appears at this time to provide less potential than the pension sector for development as a source of long-term capital. The market for life insurance is minimal, and there are historical and cultural barriers to the development of a life insurance industry.

Establishment of Accounting and Auditing Standards. In order to ensure that financial statements provide necessary financial transparency, international accounting and auditing standards need to be established and their use enforced, particularly with regard to financial statements of public shareholding companies. Currently, there are no enforceable accounting standards. To implement these standards and ensure their enforcement will require the establishment of:

- An official body to promulgate international accounting and auditing standards;
- An officially recognized, registered, and self-regulating professional body of well-trained accountants to participate in the accounting standards-setting process; and
- An oversight regulatory mechanism to ensure compliance with the application and use of international standards of accounting and auditing.

Incorporation of Professional Ethics into Financial Services Laws. A regulatory structure ensuring that investments are handled with integrity is a precondition for effectively mobilizing equity capital, but it is lacking in the current legal structure of the Palestinian Territories. There is need for specification of fiduciary duties by financial market practitioners - an enforceable code of professional ethics - which would subject all persons engaged in financial intermediation activities to strict rules of professional conduct. Rather than a single Trust Law to introduce these rules, fiduciary duties should be incorporated in the specific laws to be drafted concerning the securities market, insurance companies, and pension funds. Such laws will directly affect the activity of accountants and other professionals in the financial services industry.

While each of these technical assistance initiatives is important in and of itself, they are closely interrelated, and the full benefit of USAID's program objective of mobilizing equity capital in the Palestinian Territories will not be realized unless they proceed in tandem.

Recommendations

We have summarized our recommendations on the following pages in the form of a draft Technical Assistance Agenda (page vi), and Budgets for Proposed Interventions (page xii). Since it is not possible at this time to know what sources of expertise the Mission may utilize in carrying out its technical assistance program, budgets were prepared on the basis of rates and assumptions used in the contract for the Financial Sector Development Project (FSDP II). Actual costs to the Mission may be less than or greater than the amounts shown in these tables.

Technical Assistance Agenda

	RESULTS EXPECTED	POLICY MILESTONES	PERFORMANCE MEASURES/ M&E INDICATORS	COOPERATION EXPECTED
SECURITIES MARKET REGULATION				
1. Preparation of a Securities Law	Effective protection of securities investors' interests. Enactment of Securities Law; drafting of Securities Regulations by Ministry of Finance.	Draft law. Consultation, revisions and completion.	Quality assurance through direct observation, contacts with government agencies and concerned private parties, interim project reports, feedback to advisors and USAID.	Close collaboration with Ministry of Finance. Input from other agencies and pertinent private parties.
2. Preparation of a Company Law	Effective protection of company and shareholder interests. Government submission of draft Company Law to Legislative Council for their consideration; subsequent approval by the President.	Draft law. Consultation, revisions and completion.	Quality assurance through direct observation, contacts with government agencies and concerned private parties, interim project reports, feedback to advisors and USAID.	Close collaboration with Ministry of Finance. Input from other agencies and pertinent private parties.

	RESULTS EXPECTED	POLICY MILESTONES	PERFORMANCE MEASURES/ M&E INDICATORS	COOPERATION EXPECTED
3. Establishment of a Securities Regulator	A Securities Regulator established under the Securities Law as an independent body (though accountable to the Legislative Council), vested with statutory powers and with an executive arm funded by the securities industry. In-country workshops and seminars presented for pertinent groups. Participant training provided abroad for PSE officials (including US SEC course).	Development of an Organizational Structure (including divisions for Intermediaries/ Licensing and Supervision, Markets Supervision, Corporate Finance. Initiation of Regulator. Assistance provided to develop a Securities Law and supporting Securities Regulations.	Increased development in the fields of commerce, industry, banking and investment, as the result of a functioning legal infrastructure and as measured by interviews and consultations with private sector actors. Post-training surveys and interviews with participants.	Collaboration with Securities Law Specialist. Cooperation from Ministry of Finance. Input from other agencies and pertinent private parties.

	RESULTS EXPECTED	POLICY MILESTONES	PERFORMANCE MEASURES/ M&E INDICATORS	COOPERATION EXPECTED
PENSION/ INSURANCE REFORM				
1. Public Pension Reform	Statutory and regulatory controls in place. Discussion seminar(s) on pension alternatives held. Actuarial training (domestic and abroad) conducted or provided.	Consensus reached between governmental units on economic, social, demographic and cultural needs. Plan, design and costing of public pension alternatives examined. Compatibility with private pension schemes established. Guidelines elaborated for investment and management of public pension funds in the private sector.	Coverage underway for increasing numbers of workers by public pension scheme. Statutory and regulatory controls in place (exogenous).	Ministry of Finance/ Pension General Corporation.

	RESULTS EXPECTED	POLICY MILESTONES	PERFORMANCE MEASURES/ M&E INDICATORS	COOPERATION EXPECTED
2. Private Pension Policies	Private firm personnel trained in actuarial science. Orientation missions conducted. Periodic seminars provided on worldwide pension alternatives. Training given in fund administration/ investment management.	Establishment of a Min Labor/Min Finance Steering Committee. Drafting of regulatory and statutory documents.	Incipient functioning of private pension schemes. Increased level of understanding of pension alternatives and concepts by employers. Interviews with participants and their organizations on effectiveness of training.	Ministry of Labor; Ministry of Finance; NGOs; unions, employers, banking and insurance sectors.
3. Insurance Regulation Reform	Support for emergence of insurance industry. Legislation and regulations drafted. Creation of a regulatory body (to include industry representatives). Planning for agent licensing.	Existing draft legislation reviewed. Regulatory body established. Licensing standards determined. Continuing review and compliance.	Increased domestic investment planned by insurance companies. Insurance firms surveyed regarding acceptance of regulation and licensing standards. Increasing acceptance of insurance by client base.	Insurance Regulator (Ministry of Finance), business community, labor unions.

	RESULTS EXPECTED	POLICY MILESTONES	PERFORMANCE MEASURES/ M&E INDICATORS	COOPERATION EXPECTED
INTERNATIONAL ACCOUNTING AND AUDITING STANDARDS	Uniformity and consistence with standards established by International Accounting Standards Committee (IASC) and International Federation of Accountants (IFAC).	Regulations drafted and assistance provided to establish a Ministry of Finance accounting standards-setting body. Assistance provided to establish a unified professional accounting standards (licensing) board, from Gaza and West Bank Institutes of Accountants. Assistance provided to MOF to develop internationally acceptable accounting and auditing standards Design and implementation of a training program, consisting of international accounting standards workshops for company officials. Design and implementation of a training program, consisting of international accounting standards workshops for accountants.	Survey to determine increased number of accounting and auditing firms complying with international standards. Survey of participants and employers on effectiveness of training.	Palestinian Institute of Accountants; Ministry of Finance; accounting firms and professionals.

	RESULTS EXPECTED	POLICY MILESTONES	PERFORMANCE MEASURES/ M&E INDICATORS	COOPERATION EXPECTED
INCORPORATION OF PROFESSIONAL ETHICS IN FINANCIAL SERVICES LAWS	Fiduciary responsibilities written into laws (eventually drafted) to regulate the securities market, insurance companies and pension funds.	Intervention completed to define fiduciary responsibilities of trustees to make them applicable to financial institutions. Drafting and implementation of regulations governing the organization, management and operation of financial intermediary institutions. Increased coordination between ministries, other government institutions, firms and the academic community.	Acceptance of regulations by financial intermediaries. Increased investor confidence in legal framework. Increased numbers of prospective financial intermediaries seeking licensing.	Ministry of Finance. Also, Ministries of Trade and Economy; Labor; Planning; Justice; Monetary Authority. Palestinian Legislative Council. Business community. Academics. Labor unions. Financial institutions and insurance companies.

Budgets for Proposed Interventions

I. Securities Market Advisors

II. Insurance and Pension Reform Advisors

III. Accounting and Auditing Reform Advisors

IV. Incorporating Professional Ethics in Financial Services Law - Workshop

MOBILIZING EQUITY CAPITAL IN THE PALESTINIAN TERRITORIES

Introduction and Overview of the Planning Task

A five-person team from the Financial Sector Development Project (FSDP) reviewed and formulated a program of activities for USAID to deliver technical assistance to increase the flow of equity capital into the Palestine Territories' private sector. This involved several different components:

- ♦ Assessment of human and institutional resources as they currently exist in the Palestinian Territories,
- ♦ Development of an explicit action plan to induce desired results in financial markets, and
- ♦ Specification of qualitative or quantitative indicators that could be used to evaluate progress toward the desired financial market results.

A. Background of the Task

This assignment consisted of the review of specific interventions planned by USAID, and the development of suggestions for additional or substitute activities that would increase the likelihood of achieving two complementary goals: equity market development and enhanced capital flows in the Palestinian Territories - West Bank/Gaza (WBG).

The Design Activity Team consisted of a **Program Economist/Team Leader**, Dr. Mack Ott and four specialists:

- ♦ **Capital Markets Regulatory Specialist** - Mr. Ray Astin;
- ♦ **Institutional Finance Specialist** - Mr. Lou Enoff;
- ♦ **Accounting/Auditing Specialist** - Dr. Maureen Berry;
- ♦ **Legal Reform Specialist** - Ms. Ana Maria Linares.

While the task order provided a one-month period of field work, 18 May-15 June 1997, two members of the team (Mr. Enoff and Ms. Linares) were available for only two weeks.

The team's specialists brought substantial academic credentials and practical experience to the assignment, gained both in their home countries and in transition economies. The tasks of Mr. Astin and Mr. Enoff were well delineated focused on specific financial market areas, while those of Ms. Linares and Dr. Berry were rather broader, overlapping a number of financial market activities. Still, their tasks (the legal review and the establishment of accounting standards) were well set out in the Scope of Work; they were limited, respectively, to examining possibilities for providing assistance in the incorporation of professional ethics in financial services laws, and to suggesting ways to implement international accounting and auditing standards (IAAS).

During the month of field work, team members interviewed more than 20 officials of the Palestinian Authority and more than 60 professionals from five donor agencies and 36 private sector organizations - accountants, financial professionals and lawyers. Using findings from these interviews, insight gained from background readings and judgment from professional experience, each specialist applied his or her expertise to make recommendations for developing efficient, transparent and sustainable capital markets. From these recommendations, technical assistance and training activities were proposed.

The team recommends a substantial change in the approach to the enactment of a Trust Law. The approach recommended in this report is to ensure the inclusion of professional ethics, comprising fiduciary duties, in the individual financial market laws proposed under this program, rather than to draft a sole overarching trust law. The team also suggests a change of emphasis in the Pension Reform and Insurance. In contrast, report sections on Securities Law and Accounting and Auditing Standards are set out with details that serve largely to validate the USAID *ex ante* design.

USAID's objective is to increase the flow of equity capital to the private sector in the WBG. This objective was selected to avoid overlap with other donors' activities in related financial areas. Before examining USAID’s proposed interventions and assessing their feasibility, it is essential to verify that there exist potential capital flows to be more efficiently allocated by them. There would be no point in increasing the efficiency of financial market institutions if there were no savings flow for capital investment. We verify the substantial potential for domestic investment in the Palestinian Territories by briefly considering the capital flows - particularly, the estimated magnitude of domestic saving - which are the sources of funds for investment.

B. Levels of Saving and Capital Formation in the Palestinian Territories

Sources of Capital Flows. Besides grants and loans from international donor agencies, there are two sources of capital for investment in the West Bank and Gaza (WBG) - domestic saving and foreign capital inflows. Domestic saving shows considerable potential, as shown below. And, convincing domestic savers to select domestic rather than foreign assets for their investments is necessary to create the confidence to induce expatriates and other foreigners to make the same selection. The three categories of foreign capital inflows are:

- Repatriation of flight capital;
- WBG investment by Palestinian expatriates;
- Foreign direct investment from unaffiliated investors.

Domestic saving. Data on savings rates in the WBG are irregular and based on different income measures, but all reflect some consistent relations: Residents of the West Bank have higher incomes but, until recently, lower saving ratios than residents of Gaza. Income levels in both territories have fallen sharply since 1993. Annual data reported by the World Bank in *Developing the Occupied Territories*, (volume 2, tables 23-24) indicate that private saving in the West Bank during the last half of the 1980s varied from 12 to 21 percent of GDP, while in Gaza the saving ratio varied from 19 to 25 percent. During this interval, the per capita gross disposable income level in the West Bank grew from 2700 NIS to 4500 NIS compared with a rise from 1760 to 2760 NIS in Gaza. More recent data reported by the United Nations in its *Economic and Social Conditions in the West Bank and Gaza Strip*, Quarterly Report, Winter-Spring 1997 show that *real* per capita GDP in 1995-97 measured at 1995 prices was little changed during these three years and averaged about 2929 NIS compared with 1056 NIS in Gaza. The proportional decline in per capita income during the 1990s was about one-third in the West Bank and about one half in Gaza.

Despite declining incomes, substantial saving is generated in the Territories, especially in the West Bank. Based on surveys of household incomes and expenditures, UNSCO has estimated that household saving in Gaza in 1996 was negligible, an unsurprising reflection of the sharp declines in household income. However, in the West Bank, saving per household in 1996 was estimated to exceed 17,000 NIS, implying an annual domestic saving flow of more than 3.7 NIS billion in the West Bank.[1]

[1]Estimated savings per households in 1996 was $46 in Gaza and $5100 in the West Bank or 156 NIS and 17,340 NIS, respectively at 3.4 NIS/$. The higher household savings level in the West Bank is due both to higher household income levels and smaller household size (6.5 persons vs. 8 persons) implying a lower expenditure level. Multiplying the household saving level by the number of West Bank households yields the figure in the text. (UNSCO, 1997, pp.8,40) Our discussions with bank financial officers in the West Bank supported the significance of the West Bank private saving.

Importance of the domestic saving flow. The importance of the domestic saving flow to this assessment is that it has the potential to provide the foundation for domestic investment. The saving flow estimate is consistent with the growth of bank deposits, particularly in the West Bank: total bank deposits in the WBG have grown from $143 million in 1992 to $1,700 million at the end of 1996. Nevertheless, bank loans to WBG residents totaled only $432 million in 1996.[2] Our discussions with bank and donor agency economists and capital market planners suggest that the savings flow is currently made visible in the volume of construction, the only form of investment in the WBG which has increased in real terms during and throughout the 1990s. Construction has increased more than 50 percent during 1992-95, and up 39 percent over 1988. Construction now comprises about one-fourth of GDP (compared with an average of 17 percent during 1988-92)[3].

Economists and capital market specialists we interviewed made three things clear:

- ♦ Banks do not intend to increase their involvement in domestic investment and lending unless such assets offer better returns than foreign alternatives;
- ♦ It is also clear that the banks do anticipate that there will be such increased yields on assets;
- ♦ They are designing products for customers, both investment assets and payment alternatives (credit cards and investment funds) to attract increased savings flows.[4]

Foreign saving. The alternative source of funding for investment is foreign capital inflows. The most obvious source here is what is sometimes called flight capital. This is capital (investment assets and bank deposits and other liquid claims) of domestic residents held abroad. The motivation for such non-domestic asset choices is typically a mix of their lower capital risk, more secure property rights, and higher yields. Still, it is more convenient to invest closer to home, so domestic residents can be expected to repatriate at least some of their foreign holdings if secure domestic assets become available with attractive returns and liquidity consistent with their yields.

From Governor Beseiso's speech to the Private Sector Working Group, these figures agree with 1992 bank figures from World Bank (1993), vol. 3, p. 74; 1996 figures from World Bank (1996), p.1.

This strength persists in spite of a lack of adequate collateral security that will be amended by a soon-to-be enacted Condominium Law which will clarify and codify the mortgagor's claim on the underlying land pledged in a mortgage.

In this, they are supported by the Governor of the Palestinian Monetary Authority who argues against imposing domestic lending requirements on banks. The Governor points out that the investment in foreign government securities (Jordan) is both prudent and better than providing interest- free loans, which is, effectively, what happens when currency - Israeli shekels or Jordanian dinar - are held by Palestinian banks or individuals. Beisseso, speech at PECDAR in Ramallah, May 1997.

In addition to flight capital, former inhabitants of West Bank and Gaza living in the Diaspora hold foreign assets. It would be unreasonable to expect successful expatriates to shift their investments to the Palestinian Territories unless it were profitable to do so. Financial acumen has surely made them successful investors, and it will take hard evidence of security and profitability to attract their investment capital. Nevertheless, for former inhabitants of the West Bank and Gaza in Jordan or other parts of the region, there may be an extra attraction offered by assets in the Territories if financial policies, regulation and reporting standards increase their accessibility. Bank economists with whom we have discussed this potential estimate that former inhabitants of the West Bank and Gaza hold $10 billion in offshore assets.

Finally, a potential capital source that has been given far too little attention is foreign direct investment[5]. Developing economies with attractive investment opportunities normally run substantial balance of payments deficits, with long-term capital inflows financing current account deficits, primarily for capital goods but also for the importation of consumer products. Capital inflows are attracted by the relatively higher yields on capital investment that are possible in capital-scarce developing economies, as compared to yields in capital-rich advanced economies. Infrastructure investments - e.g., power plants and distribution networks, transport systems and roads, telecom and hospitals - are prime candidates for such foreign investments.

One example currently underway is the creation of a cellular telephone network in the WBG. A bank capital markets officer stated that the franchise for cellular telephones throughout the WBG recently has been put out for competitive tender through Merrill Lynch Investment Bank. The tender drew responses from most of the large telecom firms worldwide; sorting out the winner will take several months, but the full system is anticipated to be operational by the end of the century. This is a clear example of the kind of capital inflow that the PA could consider for many of its infrastructure investments.

C. Overview of the Findings and Recommendations

In each of the following sections, issues pertinent to each proposed intervention are set out as “the problem” and then the institutional arrangements and necessary changes to help “solve” the problem are elucidated and with specific recommendations provided. Budgets for each proposed intervention can be found beginning on page xii of the Executive Summary. Finally, in each section, USAID interventions delineated in the Scope of Work are reviewed. The consulting team concurs with most suggested interventions and they constitute the core of this report’s recommendations. However, in several cases, there are deviations from the initial USAID program specified in the SOW, concept paper and the annex.

In general, the benefits of the specific USAID interventions outlined in the Scope of Work are many orders of magnitude in excess of the relatively modest costs of supporting training, drafting laws or supporting a resident advisor. They provide the a number of the prerequisites necessary (but insufficient in themselves) for the development of successful capital markets.

D. Assessing the Recommended Intervention: Are They Worth the Cost and Which Are the Most Urgent?

The issue of developing cost-benefit perspectives for four specific proposed interventions is raised the Scope of Work as Objective 2. All four of the proposed interventions are evaluated in light of the SOW’s seven objectives in the next subsection.

Foreign direct investment (FDI) is a capital flow that results in an ownership share of 10 percent or increases an existing 10 percent or greater share. It is presumed that a stake of 10 percent or larger implies management influence, hence direction by the investor. Investment resulting in a less than 10 percent share is called portfolio investment, and is assumed to be passive not active in terms of management control.

Yet, it is useful to address the fundamental question squarely: Are any of these interventions worth undertaking, and if so, which ones are the most urgent? As stated in the Executive Summary, the overall Program is feasible. It will advance the development of the WBG capital market, and expenditures and USAID staff time devoted to its support will represent money well spent. Here, the rationale for this belief and the ordering of priorities of these four activities are set forth.

Securities Market Regulation. The Team consistently has argued that scientific cost-benefit analysis cannot be successfully accomplished within the constraints of this assignment. Nevertheless, we confidently aver that, in the case of Securities Market Regulation, the *costs* of legislating securities and company laws and establishing a regulatory structure would be vastly exceeded by the *benefits* of avoiding the financial calamity that might occur in their absence. That is, implementing regulation of the Palestine Stock Exchange and securities brokers is crucial at this time - not so much for the equity investment that it would encourage, but rather to avoid the negative consequences of fraud, insider trading or other bilking. The fallout from such scandal would do great harm to the continuing modest growth of trading activity on the exchange and resulting increases in equity investment.

Thus, the modest expenditure necessary to create a standard securities market regulatory structure (Securities Law, Unified Company Law, both with professional ethics imposed on securities market practitioners) should be compared with the costs of what it will prevent rather than just the benefits that it could help produce.

Incorporating Professional Ethics in Financial Services Laws of the Palestinian Territories. Next in priority are the professional ethics to be incorporated in the various financial services laws proposed herein for USAID's program. These fiduciary duties will, like Securities Market regulation, be valued in part for what they prevent - fraud, abuse of investor trust, and low-quality service which would damage the attractiveness of investment in equities and other securities in the Palestinian Territories. However, these professional ethics will also encourage investment by reducing risk and lowering uncertainties associated with investment. By reducing risk, investment is made more attractive, and the decision to invest becomes more one of informed analysis and choice than a gamble.

International Auditing and Accounting Standards. As the relative importance of information rises in the investment decision - i.e., uncertainty about the transaction process becomes negligible - accounting and auditing standards become important to encouraging investment. There will be an immediate and profound impact from providing the assurance of no fraud transactions through the provision and enforcement of professional ethics in the financial services industry.

The impact of accounting and auditing standards will not be as immediate or direct. Nevertheless, ensuring completeness and transparency in financial reporting will still provide substantial benefits by helping investors to make better-informed decisions, thereby improving the efficiency of the economy's capital allocation. For these improvements in the financial market to occur, establishment of accounting and auditing standards will be quite important.

Pensions and Insurance Reform. Finally, least urgent in the team’s view is development of pension and insurance investment programs. Pension funds are currently relatively secure, as either part of Israel's social security system or, in the case of the Gaza Pension Fund, being held in Swiss bank deposits. In both cases, the first requirements are for regulatory structure and skilled investment management. Once this is done, consideration of the choice of vehicles to provide for increased equity investment by these funds will become appropriate. Until regulatory structures are in place, however, design of investment mechanisms would be premature. With respect to neither issue - transfer of control to the Palestinian Authority or design of appropriate regulatory constraints and separation from other governmental finance - is there the urgency associated with stock market regulation or professional ethics.

Conclusion. While securities regulation and professional ethics are the most urgent policy concerns for mobilizing equity capital in the Palestinian Territories, each of the four activities - securities regulation, professional ethics, accounting and auditing standards, and pension reform - is worth undertaking. For each, the cost of implementation (whose direct outlays are described in the budgets beginning on page xii) is modest, relative to both the financial damage avoided by their undertaking and to the long-term benefits of increased equity capital flows that they will encourage.

E. Cross-check of Recommended Technical Assistance with Objectives in SOW

The assessment of the recommended set of interventions against a group of seven objectives is required by the Scope of Work. In this section, the proposed technical assistance initiatives are cross-checked against the seven criteria specified in the SOW as “objectives of the team” which, for reference, are paraphrased as follows:6

1. Analyze contribution to the mobilization of equity capital;
2. Analyze the relative costs and benefits and its linkages with other proposed initiatives;

Delivery Order under Contract No. PCE-Q-00-93-0071-00, 7 May 1997, p. 5.

3. Confirm the counterpart relationships;

4. Describe the structure, costs and recommended sequence;

5. Analyze constraints on designed impacts and estimate likelihood of success;

6. Recommend results framework structure and design a monitoring plan;

7. Describe policy milestones and the extent of required cooperation among partners and stakeholders.

Monitoring. In addition, enumeration of indicators that could comprise skeletal, preliminary monitoring plans for the four initiatives assessed is included in item 6 of the sections covering each initiative.[7] Complete and detailed monitoring plans will, of course, be part of final work plans when they are drafted. The details of the proposed recommendations are in the four Sections that follow, and the budgets for each appear above on p. xii and following. A number of monitoring and evaluation indicators and performance measures are also provided in the table beginning on page vi of the Executive Summary, "Technical Assistance Agenda."

Securities Market Regulation.

1. In the absence of a proper legal structure which includes a Securities Law and Company Law, there is no chance for capital mobilization. There cannot exist a credible capital market without a suitable legal structure to ensure financial transparency and transaction performance. Therefore, capital flows into equity investment cannot exist or persist *absent* the framework this technical assistance will provide.

2. Securities and Company Laws, together, will require companies to provide investors with financial information covering the gamut of their interests. The costs of the proposed technical assistance - basically three resident advisors - loom small against the benefits of the sustained capital flows the intervention will support.

Linkages with other interventions assessed are substantial for the Securities Law and Company Law, primarily with the establishment of accounting and auditing standards. Accounting and auditing standardization will ensure that financial information is transparent and provides proper comparisons between companies - allowing investors to compare apples with apples rather than apples with pears. There is also synergy with efforts to ensure that fiduciary responsibilities are enacted in the Securities and

These were set out above in the Technical Assistance Agenda matrix that appears at the conclusion of the executive summary on pp. vi-xi.

Company Laws and through the proposed workshops; policy dialogue will not only assist in passage of the laws necessary for Securities Market regulation, but will also serve to inform both those involved in legal/enforcement efforts and financial practitioners of each others' interests and concerns.

3. The counterparts are as follows: For the Securities Law resident advisor, the counterpart for securities policy input will be the Ministry of Finance, while the counterpart for local law, legal drafting and legislative process will be the Ministry of Justice; for the Company Law resident advisor, the counterpart will be the Ministry of Economy and Trade in the West Bank and Ministry of Justice for company law policy input in Gaza and for both territories for legal drafting and legal process; finally, for the Securities Regulator resident advisor, the counterpart will be the Ministry of Finance.

4. Detailed discussion of the issues and specification of the recommended technical assistance are contained in the Section I, and the recommended budget appears following p. xii.

5. There are substantial impediments to the enactment of needed laws and regulations, related to (i) the lack of a comprehensive legal infrastructure, (ii) the largely untried legislative process and its inexperienced members. The latter may be considered simply to be a characteristic of the democratic process rather than an impediment, but in any case, the strategy for dealing with political inertia is to support the resident advisors' efforts to effect change. There is a high likelihood of success since the Ministries of Finance and Justice want help to implement the regulatory structure.

6. Benchmarks here are self-evident - to place before the Cabinet a draft Securities Law and a draft Companies Law. Of course, complete success requires enactment, and the resident advisors in the counterpart ministries (see above at **3.**) provide the process and the mechanism for tracking.

7. The success of these initiatives is dependent upon the willingness of counterpart ministries to act. Fortunately, all three (Ministries of Finance, Justice and Economics & Trade) have assured cooperation.

Reforming Pensions and Insurance.

1. Pension (and Insurance) reform would bring substantial pools of investment capital under the control of the PA, including funds that are currently controlled by the Government of Israel and funds that are lying relatively dormant (according to the IMF) in Swiss bank deposits. Yet, as discussed above, there is no urgency to do this and much reason to proceed slowly and prudently. Until there is adequate regulation of pensions and clear restrictions on the use of their funds, it is better to leave the funds where they are. As soon as the pension (social security) law is in place, the PA will take control of funds currently managed on behalf of the Palestinian workers in Israel. The most important issue here, then, is not speed or timeliness, but assurance of fund separation from general government revenues. Further, when the funds are controlled by the PA, the trustees' responsibilities may well argue against investing in the Palestinian Territory if Jordanian, US, or even Israeli securities have higher and more secure returns. Thus, the potential for equity capital mobilization from this source is likely to be deferred and probably small.

2. Investment of Pension Funds and Insurance Reserves will be made feasible by Securities Market regulation and professional ethics in financial services. Without these, risk would be too high for trustees (government or private) to invest in Palestinian equities. Once these other reforms are in place (including professional ethics in Insurance and Pension program sales), then investment overseen by pension trustees and insurance reserve managers will be feasible and attractive to these funds.

3. As discussed in Section II, the Ministry of Finance will be the main counterpart for regulation of pensions and insurance. For some private pensions, the Ministry of Labor may be involved with the Ministry of Finance.

4. Detailed discussion of the issues and specifications of the recommended technical assistance are contained in Section II, and the recommended budget appears following p. xii.

5. The chief constraint to interventions designed for pensions is the lack of pension regulatory structure. In the case of insurance, both regulatory structure and market potential are lacking. Social and Islamic customs reduce the potential market for life insurance; casualty insurance may hold potential for equity investment, but only in limited amounts for long-term investments in comparison with life insurance.

6. The most important result of a successful intervention will be an increasing number of workers covered by public pension schemes. Private pension coverage should also become increasingly common. Expansion of the insurance industry may be relatively slow. Pensions and Insurance Advisors will closely monitor achievements in this area, together with enactment of necessary statutory and regulatory controls.

7. A number of discrete policy milestones will need to be attained. First, it will be necessary to achieve consensus on the objectives of Pensions legislation and related control mechanisms. It will also be necessary to cost out alternatives, and create a better understanding of actuarial models for alternatives plans. Compatibility with existing or planned private sector schemes will also be required.

Establishment of Uniform Accounting and Auditing Standards.

1. None of the proposed interventions are directly linked to the stimulation of inflows of equity capital through increased market transparency, efficiency, and investor confidence. However, by comparing the increased value of the capital markets in transitional economies where such policy initiatives were adopted in the early stages of the markets' development, such as Poland and Hungary, with those where they were not adopted, such as the Czech Republic and Russia, it can be argued that accounting and auditing practices are crucial elements of a capital market's foundation (see above at Securities Regulation).

2. The policy initiative underlying these interventions, namely, of establishing uniform accounting and auditing standards to enhance market transparency, efficiency, and investor confidence, cannot be achieved unless the recommended infrastructural changes are made. That is, uniform accounting and auditing standards cannot be established until there exist both a standard-setting institution and an adequately and properly trained, regulated, professional body of accountants to carry them out. As a result, the estimated benefits of the proposed interventions, in financial terms, are synonymous with the values assigned to market transparency, efficiency, and investor confidence. As noted above, there is substantial linkage with the implementation of Securities Regulation.

3. The counterpart relationships included in the proposed interventions of the consulting engagement's terms of reference are: (i) the Ministry of Finance for the development of legally acceptable accounting and auditing standards and the Ministry of Justice for the drafting of proposed interventions requiring legislation; and (ii) the Palestinian Association of Accountants for a compliance program. One transient problem is that the existing Associations of Accountants in Gaza and the West Bank are not officially registered so counterpart relationships with these two institutions would only be on an informal basis until a properly constituted, officially recognized, and regulated body is in existence.

4. Proposed interventions in the accounting and auditing-related areas are elaborated in the first part Section IV, with costs considered later in the same section.

5. The constraints to achieving the desired impacts relate to the cumbersome nature of the legislative process which will delay badly needed initiatives, as discussed in the Securities Regulation section above. There is a high likelihood of success for each of the proposed interventions because the main counterparts recognize the related problems, and they are likely to cooperate fully with USAID provided technical assistance.

6. Monitoring indicators, aside from the obvious legislative enactment, are the growth of the market as a whole as a proxy measure for successful achievement; the number of accounting and auditing firms in existence and the starting salaries of qualified graduates of WBG university graduates; and the number of accounting firms complying with international accounting and auditing standards.

7. Once again, the policy milestones are the passage of two key laws, (i) to mandate regulations establishing an accounting standards setting body as well as in its implementation, and (ii) to assist in the establishment of an officially recognized, registered, self-regulatory professional accountancy body which will be empowered, *inter alia*, to participate materially in the promulgation of internationally acceptable accounting and auditing standards and to enforce a professional code of ethics.

Incorporation of Professional Ethics in Financial Services Laws.

1. Like accounting and auditing standards, professional ethics make investment analysis more transparent. The accounting and auditing standards do this by increasing the ease of comparing companies to determine likely profits and growth potential. Professional ethics accomplish this by reducing risk of loss due to fraud or incompetence in the handling of transactions or the safe custody of securities. Reducing the cost of that risk - by raising professional standards - increases the expected rate of return on investments.

2. Linkages between professional ethics and accounting and auditing standards are immediate - part of the proposals for accounting and auditing standards is to establish minimum competencies, educational attainment for entry, requirements for continuing professional education, examinations for licensing, regulations and sanctions. Thus, the synergies here are due to both interventions sharing common elements. Similarly, with respect to the Securities Market Regulation, rules governing broker performance are also part and parcel of professional ethics in that financial service sector. In the case of Pension and Insurance reform, the interplay for fiduciary representatives is like that for securities brokers. However, our recommendations for Pensions and Insurance reform are more focused on establishing actuarial soundness in management of reserves and developing pension and insurance regulation over reserve management.

3. While the proposed intervention is not a single general Trust Law, the primary counterpart remains the Ministry of Finance. Except for the Company Law, each of the financial market laws in which professional ethics will need to be inserted - Securities Law, Accounting and Auditing Standards, and Insurance Regulation - falls within the purview of the

Ministry of Finance. For the Company Law, the Ministry of Finance shares oversight responsibility with the Ministry of Justice and the Ministry of Economy and Trade.

4. Details of the proposed intervention are developed in Section IV, and the recommended budget for the workshop is provided following p. xii.

5. Like the proposed regulatory structure for the Securities Market, the constraint to incorporate professional ethics will be the lack of a comprehensive legal structure and the untried legislative process. Still, the chances of success are high because the tasks are add-ons in each sector, and there appears to be enthusiasm among professionals and institutions (e.g., the Palestine Stock Exchange) for regulatory structure to give their professional practice quality controls with which to attract customers. The workshop's raison d'etre is to make legislators and regulators aware of the need for specific fiduciary responsibilities to be assigned while ensuring inputs from the professionals who will be regulated. With both sides agreeing on various aspects of regulation, it will be easier for legislation to be enacted into law. Major constraints are lack of awareness and lack of coordination; these will be confronted by the advisors.

6. The Team has substantially redesigned this proposed intervention by substituting individual, industry-specific professional ethics (comprising fiduciary duties relevant to specific financial services activities and practitioners) for a general Trust Law.

7. To achieve cooperation among regulators and legislative draftsmen with input from the regulated professionals is the purpose of the workshop. From this will come suggestions for draft professional ethics from the regulators and feed-back from the practitioners. The policy milestones are the new laws with the professional ethics or the incorporation by amendment to existing laws.

F.

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I. Developing Securities Market Regulation in the Palestinian Territories

Introduction

Notwithstanding the February 1997 opening of the Palestine Stock Exchange (PSE), the Palestinian Territories lack the legal infrastructure necessary to regulate securities markets. The lack of a Securities Law - and other governmental regulatory mechanisms - severely impedes development of market intermediaries. These intermediaries, in turn, are vital for the mobilization of private savings.

Recommendations. To remedy this situation, USAID should conduct four specific interventions, as stated below. A fifth intervention, a training component, would span the others.

1. A Palestinian Securities Law should be developed;
2. A new Palestinian Company Law should be developed;
3. A Securities Regulator should be established to administer and enforce the proposed Securities Law;
4. Resident advisors should be commissioned to lead each of these three technical assistance tasks;
5. Training for government officials and securities industry executives should be provided, in the form of seminars, workshops and orientation missions.

Securities Law. The PSE currently has a modicum of internal regulation. Yet, experience in numerous countries has shown that self-policing alone by exchanges is wholly unsatisfactory. Since the PSE's founding, the level of share turnover and the number of companies listed have fallen short of original projections. This situation will not change until the PSE is supported by a credible Securities Law and an external Regulator.

The Securities Law should constitute a statutory framework setting out the basic structure, principles, and rules of the regulatory system. It should be supported by subsidiary legislation providing the details of regulations made under enabling powers contained in it. Key regulations would cover the Conduct of Business, Accounting and Financial Requirements for licensees, Prospectuses, the Continuing Disclosure Obligations of Public Issues, Advertising, and Investment Funds.

Company Law. An appropriate Company Law is an essential part of the legal infrastructure. The present company law of the Palestinian Territories is fragmented, outdated, and wholly inadequate. The development of a unified Company Law should proceed together with the development of a Securities Law.

Securities Regulator. A Securities Law comprising the statutory framework for a securities regulatory system designed for the protection of investors would, as a first step, establish a Securities Regulator with responsibility for oversight over all types of securities business and the various professional market participants.

The Securities Regulator should be empowered to exercise regulatory oversight in three distinct ways. First, by requiring market professionals and all types of securities business to be licensed on the basis of specified criteria. Second, by supervising and monitoring all licensees and licensed businesses. Third, by ensuring that listed companies comply fully with their listing obligations.

The objectives and functions of the Securities Regulator should be specified in the Securities Law. The Securities Regulator should be established by the Securities Law as an independent body with the majority of its members voluntarily recruited from the private commercial sector.

Methodology. This section reflects conclusions reached as the result of a series of internal team meetings, meetings with the USAID Mission, a series of meetings held with Safwan Bataina, General Manager of the Palestine Securities Exchange, and a number of in-depth meetings held individually (some on more than one occasion) with the organizations specified in the Schedule of Meetings attached as Annex I.

A. The Palestine Securities Exchange (PSE)

The Palestine Securities Exchange (PSE) began share trading operations on February 18, 1997. Although the PSE operates under limited internal rules of control through a Constitution, Membership Rules and Listing Regulations (drafted by the Exchange management), these have not yet been published. According to the General Manager of the PSE (Safwan Bataina), they will not be published until a general securities conference is held and all interested parties reach agreement on them.

The PSE Constitution presumes the enactment of a Securities Law by the Palestinian Authority (PA), under which proposed Law the PSE will be established as "a separate organization independent in respect of financial and administrative matters." Article 6.1 of the Constitution provides that it shall come into force upon ratification by the Ministry of Finance of the PA. The PSE submitted the Constitution to the Minister of Finance for ratification in July 1996, but no reply has been received by the PSE. However under clause 6.1 it is deemed by the PSE to be valid because it was not rejected or qualified by the Minister within the stipulated 30 days.

The PSE has four established members: (1) Jordan & Palestine Financial Investment Co. (a subsidiary of the Housing Bank), (2) Al-Watanieh Securities Co. (a subsidiary of the Cairo-Amman Bank) (3), United Securities Company, and (4) Target Securities. Two other securities companies have been accepted for membership by the PSE (one of which, the International Securities Co., is a subsidiary of the Palestine Investment Bank, which is itself 55 percent owned by Arab Bank) but they have not yet begun operations.

The PSE presently has 25 public shareholding companies listed and has identified another 12 companies which meet their listing criteria but which have not yet applied for listing (but which would be subject to "compulsory" listing if it were enforced by the PSE).

The Palestine Securities Exchange Co. Ltd (PSEC). The Palestine Securities Exchange Company Ltd. (PSEC) has entered into an agreement with the PA for the PSEC to manage the PSE. This Agreement, dated 7 November 1996, authorizes the operation of the PSE subject to the supervisory control of the Minister of Finance. It provides that the Minister of Finance will develop a Securities Law; that it will exercise supervisory control over the securities market of the PSE, and that it will ensure that all listed companies comply with the listing requirements of the PSE including, in particular, the disclosure requirements. In essence, the Minister of Finance will be responsible for the primary market and the PSE for the secondary market. The PSEC is a private shareholding company owned by PADICO (65%), SAMED (20%) and the balance by three other companies.

Current status of the exchange. In its implementation plan for a "Palestine Capital Market Project," the PSE envisioned three distinct phases:

♦ Establishment of a securities market regulator (referred to as the Capital Markets Bureau).

- Establishment of a securities exchange.
- An educational and training program.

To date, only the second phase has been implemented, although there has been some internal training for PSE staff.

The level of share turnover and the number of listings on the PSE have fallen short of projections. In addition the number, and perhaps the quality, of companies listed has proved disappointing. But projections were perhaps overly optimistic, and the present political uncertainties have undoubtedly had a negative effect. At any rate trading volume and listings have recently shown signs of improvement. At this point the low trading volume is not a cause for serious concern, because trading volume will grow with investor interest which currently is not attracted to listed stocks. Moreover, the matter of quality is one that the market price mechanism will take care of as long as regulations require full disclosure and audited accounts.

The primary concern, then, is that a proper regulatory structure should be created as soon as possible by the enactment of a Securities Law and the establishment of an external Regulator. The PSE needs the credibility that will be afforded to potential investors by the enactment of a Securities Law and the establishment of an external Regulator. Without this credibility, overseas institutional investors and well-to-do expatriate Palestinians will not venture into the market. Indeed, even local investors, particularly institutions, are likely to avoid it.

PSE Self-Regulation. The PSE is in reality presently regulated of itself, by itself, for itself. Experience has shown that, for a variety of reasons and in particular due to inherent conflicts of interest, self-policing alone by stock exchanges is wholly unsatisfactory. While self-regulation by market professionals will always be the cutting edge of securities regulation, it must be reinforced by the creation of a supervisory and monitoring body.

Market Credibility and External Regulation. Credibility is the key to a successful market. Experience has shown that self-regulation alone will not achieve this. A credible market provides fair and orderly trading, fair competition on a level playing-field, full and timely disclosure by listed companies, ready and timely availability of price and transaction information plus efficient and economic execution of trades and assured settlement.

A stock exchange regulated solely by itself suffers, inevitably, from inherent conflicts of interest between its regulatory obligations and its commercial interests. That is, exchanges may frequently be required to act in the public interest even though doing so may conflict with interests of their members. An exchange which is free from any external oversight cannot always be relied upon to take the proper course of action. There is also the danger of an exchange's susceptibility to "regulatory capture" i.e. the situation where an exchange becomes primarily a "club" for the benefit of its members at the expense of outside investors. Self-regulation may be equated with self-interest and fail to take into account the protection of investors and the broader public interest. Self-regulation, then, may be used to stifle competition. In addition, it may lead to uneven application of rules and a preoccupation with costs and efficiency. In any event, a major practical restriction of self-regulation is the limitation on its jurisdiction to persons who are members.

B. Lack of Proper Legal Infrastructure

The legal infrastructure includes both the regulations and the regulators that enforce them. Both being necessary to achieve the desired credibility that sensible regulation entails, we consider the roles of each and what are the minimum constituents of a satisfactory legal infrastructure.

A comprehensive legal infrastructure, encompassing commerce, industry, banking and investment, is essential to the economic development of a market economy. The Palestinian Territories lack this infrastructure. Without the degree of certainty and confidence that such a framework provides, prospects for financial sector development are poor. As noted by IPCRI, in its report on Banking Law Reform in the Palestinian Territories (December 1995), "The Law of the Palestinian Territories is a largely incoherent amalgam left behind by the region's various previous rulers and occupiers. Dormant since the intifada, the newly active legal system now struggles with the prodigious tasks of re-establishing its authority and reforming almost all existing laws. In the meantime, different laws remain in force in the West Bank and Gaza Strip, as well as those parts of each territory which are under the authority of the Palestinian Council and those which are not."

Securities Law. A Palestinian Securities Law should be developed which is not only appropriate to present and foreseeable needs but which is also in accordance with international standards. Of note is the recent Jordanian Securities Law of 1997 (paragraph 15). This Law was drafted by a Jordanian law firm (commissioned by the World Bank), assisted by Merrill Lynch and a New York law firm. We have spoken to Shari Zubi of the Amman firm, who informed us that they are very unhappy with the

Law as eventually enacted; 110 clauses were deleted from their draft in the legislative process. The emasculated version omitted a number of critically important provisions covering matters such as insider trading, disclosure by listed companies in accordance with International Accounting Standards (notwithstanding that the accountancy profession in Jordan expressed themselves as being happy with the introduction of IAS), various regulatory and supervisory powers, trust provisions (deemed important for mutual funds) and limitations on the abilities of Commission members to trade shares and requirements for the disclosure of any share holdings.

Shari Zubi concluded that the Jordanian Law does not meet internationally accepted standards. It represents very little improvement over their previous Law, which was generally regarded as unsatisfactory and inadequate.

Company Law. Under an acceptable legal infrastructure, an appropriate Company Law is an essential counterpart to a Securities Law. The present company law of the Palestinian Territories is fragmented and outdated. The relevant company law for the West Bank is the Jordanian Companies' Law of 1964. It is overseen by two Controllers of Companies who are based in Ramallah and Jericho, respectively. Both Controllers are accountable to the Minister of Economy & Trade. The relevant company law for Gaza is the British Mandatory Companies Ordinance of 1929 (as subsequently amended) which is implemented by a Registrar of Companies based in Gaza and accountable to the Minister of Justice.

Jordanian law does not provide a paradigm for the Palestinian Territories. Quite apart from the marked differences between company laws for the West Bank and Gaza (and the obvious need for one unified Law for the Palestinian Territories), both Jordanian laws fall dramatically short of many of the basic needs of corporate governance. For example, the Jordanian Companies' Law of 1964 contains no provisions on prospectus requirements for the public issuance of shares, nor for the content of a company's accounts or the continuing disclosure obligations by public issuers to shareholders or the public. It does not even provide for the transfer of shares. While the Companies Ordinance of 1929 is much more comprehensive than the Jordanian Companies' Law, it nonetheless suffers from serious shortcomings. But, since it is familiar to one half of the Palestinian Territories, it could constitute the basis for a unified and revamped company law.

Whatever the shape or origins of a unified company law, its development must proceed in parallel - and in harmony - with the development of the recommended Securities Law.

Securities Regulator. Although different jurisdictions have different opinions on the optimum system of securities regulation, the desired degree of regulation and, indeed, on who should regulate (a ministry, e.g. the Ministry of Finance, another government agency charged specifically with regulation, a wholly independent regulatory body, even self-regulation alone, or a combination), there is universal agreement on one issue in all the developed securities markets: without proper and effective regulation, a securities market will not enjoy credibility. And without credibility a market will not attract players. Without players, the market will lack liquidity. Without liquidity there cannot be a successful market.

Limitations on Regulatory Reach. The importance and reach of external securities regulation must not be overstated. Limits were expressed well by Professor Gower, the author of the report on the UK investment business industry which led ultimately to the UK Financial Services Act 1986, when he said "the objective of regulation is not to achieve the impossible task of protecting fools from their own folly, but rather to try to prevent people being made fools of." The role of regulation is to ensure that the securities market is honest, fair and competitive, and that information is equally available to all players. Given the level playing field provided by full and timely disclosure, each player can decide, rationally, which securities to buy or sell and when.

The regulatory system must also recognize the need to draw the line between proper and effective regulation, and over-regulation. The latter can kill the very market that it was designed to encourage. Within markets, there is a natural tendency to regard any form of regulation as negative. While there are admittedly negative aspects to regulation, it is important for markets to bear in mind the positive aspects of regulation; namely, to foster and promote securities markets for the overall benefit of the economy, for the benefit of the investing public and, for the benefit of market professionals.

C. Instruments to Establish Proper Legal Infrastructure

The Securities Law and Subsidiary Regulations. The purpose of the Securities Law is limited to providing a statutory framework setting out the basic structure, principles and rules of the regulatory system. The law will need to be supported by subsidiary legislation providing the details of regulations made under enabling powers contained in the framework Law. Putting the details of securities regulation in subsidiary legislation provides the necessary flexibility for changes in the fast-moving modern commercial world. In addition to licensing regulations, key regulations should include the following:

Conduct of Business Regulations. These regulations will require that licensed professionals, in dealing with or for customers, must at all times in their conduct of securities business, act according to the principles of best practice. In particular, they should require high standards of integrity and fair dealing, due skill, care and diligence, and observation of high standards of market conduct. The regulations should state the ten basic principles, promulgated by the Securities and Investment Board (SIB) the senior City of London securities "watchdog", relating to integrity, due skill, care and diligence, market practice, information about customers, information for customers, conflicts of interest, customer assets, financial resources, internal organization and relations with the Regulator.

Specific regulations for conduct of business will deal with matters such as:

- Independence,
- Disclosure of material interests,
- Customer order priority,
- Timely execution,
- Best execution,
- Timely allocation,
- Fair allocation,
- Front running,
- Churning,
- Segregation of customer moneys and securities,
- Safeguarding of customers' investments,
- Establishment of complaints procedures, and
- Supervision of employees and customer confidentiality.

Accounting and Financial Requirement Regulations. These regulations will:

- Detail the accounting records to be maintained by brokerage and other firms including requirements as to updating, retention, conformity with accounting standards, reconciliation of customer moneys and creation of an audit trail, and should provide for their inspection by or on behalf of the Regulator,

- Require the preparation of annual financial statements in accordance with International Accounting Standards (balance sheets and profit and loss accounts, and cash flow statements, which give a true and fair view), together with such other periodic reports as may be considered necessary, specify the form and content of financial statements, require them to be audited and specify the contents of auditors' reports and the procedure in the case of qualified reports, and require the submission of annual financial statements to the Regulator;

- With regard to customer money, impose a duty to segregate it from other moneys, impose a duty to keep it safe, require the opening of customer bank accounts, control the accounting for and use of customer money, restrict payments out of customer bank accounts, and make appropriate provision for the safeguarding of customers' other property;

- Prescribe the required financial resources with regard to minimum net capital and minimum liquidity margin; and

- Provide for the compulsory appointment of independent qualified auditors.

Prospectus Regulations. These regulations would cover issues of securities that are to be publicly traded. They would complement the limited requirements for prospectuses under the Company Law, covering matters such as capitalization, history and nature of business, fixed assets, summary of earnings, tabulation of balance sheet, employees, subsidiaries, dividend record, profits cover, net tangible assets, voting rights, details of indebtedness, turnover, financial and trading prospects, sufficiency of working capital, directors' interests, directors' contracts, material contracts, use of the proceeds of issue, properties, pending litigation and management.

Continuing Disclosure Obligation Regulations. Continuing disclosure obligation regulations will impose a duty on public issuers of securities to keep members and other holders of its securities fully informed as soon as reasonably practicable of any information relating to the issuer (and any subsidiaries) that (a) is necessary to enable them and the public to appraise the financial situation of the issuer, (b) is necessary to avoid the establishment of a false market in its securities, and (c) might reasonably be expected materially to affect market activity in the price of its securities.

In particular, these regulations would be concerned with the delivery of accounts, interim reports, the acquisition and disposal of assets, transactions with related companies where the issuer is a subsidiary, the closure of the issuer's books, notice of annual general meetings, distribution of directors' reports and annual accounts, the information to accompany those reports and accounts, the declaration and payment of dividends, board meetings, actions after board meetings, the basis of allotment of shares, preemptive rights of shareholders, and sanctions.

Consideration should also be given to the power to impose fines on directors, in their personal capacity, for breach by their company of its continuing disclosure obligations.

Advertising Regulations. Advertising regulations should restrict the issue of securities advertisements (i.e. advertisements for or in connection with securities or securities business) to licensed market professionals, and such other persons as may be approved for the purpose by the Regulator. They will empower the Regulator to issue directions to advertisers in respect of unsatisfactory advertisements; they will require that a copy of every advertisement published shall be forwarded to the Regulator; they will require the contents of advertisements to comply with various specified provisions relating to advertisements being clear and not misleading, to be distinguished from other matter, promotions to be genuine, synopses to be fair, not to imply Governmental approval, and controlling references to comparison with other investments or services, taxation, cancellation rights, past performance, indication of scale of business activities and guaranteed returns, with a universal requirement that all securities advertisements shall contain appropriately worded risk warnings.

Investment Fund Regulations. The development of an investment fund industry (i.e. collective investment schemes such as mutual funds and unit trusts) is important both for the mobilization of private savings and for the growth of business on the PSE. Investment funds offer both professional management and risk spreading; they are likely to prove more attractive to unsophisticated investors than portfolios of stocks that they select independently. Domestic investment funds are also likely to be attractive to national pension and insurance funds.

Before they can be promoted to the public, investment funds should be authorized by the Securities Regulator, under the Securities Law. Regulations will govern such matters as authorization criteria and conditions, constitution and management of funds, powers and duties of the fund managers and custodians, rights and obligations of fund participants, promotion, marketing and distribution of units, issue and redemption of units, provision of management and custodial services, regulation of investment and borrowing powers exercisable by the fund, requirements for preparation of periodical reports their presentation to participants and the Securities Regulator, and requirements for fund transaction and financial position records and their inspection.

Securities Law and the Framework for Regulation. A Securities Law, constituting the statutory framework for a securities regulatory system designed for the protection of investors, would as a first step establish a Securities Regulator with responsibility for oversight over all types of securities business and the various professional market participants. The Regulator would be empowered to exercise oversight in three distinct ways:

- By requiring market professionals and all types of securities businesses to be licensed;
- By supervising and monitoring all licensees; and
- By ensuring that listed companies comply fully with their listing obligations.

Licensing of Practitioners. All individuals engaged in the conduct of securities business should be licensed to do so. As a corollary, the conduct of securities business by any person who is not so licensed should be made unlawful. Exactly the same principle should apply to securities exchanges, clearing houses and depositories. It is of course a given that the Regulator will not license any person or body unless and until he is positively satisfied that the applicant is in all respects suitable for the business proposed. Thus, for example, in the case of broker/dealers, only persons who can establish their "fitness and properness" to engage in brokering/dealing should be licensed to do so.

In order to determine whether a person is fit and proper, the Law should require that the Regulator have information regarding to the applicant's:

- Financial status,
- Financial integrity and reliability,
- Possession of suitable experience and/or educational or other qualifications, and
- Good reputation and character.

But the Regulator should not be confined to these matters as disclosed in applications. Rather, it must be empowered to investigate any aspect of the applicant's background or former conduct.

Monitoring the Exchange and Its Members. Having exercised the appropriate degree of quality control over licensing, the second element of regulatory control is to ensure that market practitioners in fact conduct their licensed business activities efficiently, honestly and fairly. This involves the Regulator in positive monitoring and supervision of their activities.

This supervisory and monitoring rule will be enhanced and simplified by the creation of an appropriate "rule-book" which will cover matters such as conduct of business, principles and rules, financial and accounting requirements, advertising, prospectus requirements, and continuing disclosure obligations of listed issuers. Such a rule-book should seek to establish clear parameters for what is "good practice" and what is unacceptable. This is not merely for the benefit of the Regulator itself; it also constitutes guidelines for market practitioners and informs the investing public of the services that it might reasonably expect.

Listing compliance. Third, the Regulator must ensure that listed companies comply with all the terms and conditions of their listing agreement with the Exchange (this agreement will require compliance with the Securities Law and the Regulations made under the Law).

To administer and enforce the proposed Securities Law, it is necessary to establish an independent Securities Regulator. Without such a regulatory body, the PSE will continue to be perceived, at least by foreign institutional investors, as an "unregulated" market.

Objectives of the Securities Regulator. The objectives of the Securities Regulator are as follows:

- To take all reasonable steps to ensure that the Palestinian securities market is fair, efficient, competitive and informed;
- To develop and implement fair, concise and clear legislation, regulations, rules, guidelines and procedures;
- To encourage the development of the securities market in the Palestinian Territories and the increased use of the market by local investors and overseas investors;

- To ensure that the regulatory regime is structured and operated in a cost-effective and constructive manner;
- To encourage responsible and effective self-regulation by the PSE;
- To ensure the existence of effective risk management measures which are designed and operated in accordance with internationally recognized standards;
- To enhance the quality of the Palestinian securities market and to ensure that the skills and expertise of professional market participants are consistent with both current and future market needs, and to accomplish this through the encouragement and facilitation of a comprehensive industry training program;
- To maintain and enhance effective compliance and enforcement programs supported by adequate statutory powers;
- To enhance communication channels with market participants and to use these effectively;
- To maintain contingency plans to deal with potential market disruptions;
- To promote proper understanding and support for the Securities Regulator's role and objectives; and
- To ensure that the Securities Regulator's staff possess market knowledge and professional capabilities of consistently high quality to ensure an effective regulatory environment.

Functions of the Securities Regulator. The functions (i.e. powers and duties) of the Securities Regulator should be expressly set out in the Securities Law, along the following lines:

- To ensure compliance with the Securities Law, and regulations made under it;
- To license, supervise and monitor the activities of, the securities market, clearing houses, share registrars and depositories;
- To license, supervise, and monitor the activities of broker/dealers, investment advisors, investment/fund managers and their respective representatives;
- To set standards of competence for the grant of licenses by way of examination or otherwise;
- To authorize and regulate investment funds (all forms of collective investment schemes such as mutual funds and unit trusts);
- To monitor and enforce rules for the conduct of business by licensees including revocation and suspension of licenses;

- ♦ To promote and encourage high standards of investor protection and integrity by licensees and to encourage the promulgation by licensees of balanced and informed advice to their customers and to the public generally;
- ♦ To support the operation of an orderly, fair and properly informed securities market;
- ♦ To regulate the manner of trading and the range of securities traded on the PSE, and to approve its rules with regard to membership, listing, margins, capital adequacy and liquidity, disclosure, periodic reporting, the reporting of transactions and trade clearance and settlement;
- ♦ To take all reasonable steps to safeguard investors and to suppress illegal, dishonorable and improper practices in dealings in securities and in providing advice or other services relating to securities;

To cooperate with and assist other regulatory authorities in the Palestinian Territories or elsewhere that are concerned with securities or with the affairs of companies.

Recommended Structure and Composition of the Securities Regulator. Ideally, the Securities Regulator should be established by the Securities Law as an independent body (though accountable to the Legislative Council), vested with statutory powers and with an executive arm funded by the securities industry.

In light of the present circumstances of the Palestinian Territories, the Securities Regulatory Board should be composed of members nominated by the Ministers of Finance and of Economy & Trade, together with representatives from the banking industry, the legal and accounting professions, the PSE and listed companies. What is critically important in order to enhance the Regulator's acceptance and credibility is that the majority of members should be recruited from the private sector.

Members will serve on a part-time, voluntary basis. They would be responsible, broadly speaking, for all policy and other major decisions. The Board would be serviced by an executive arm, which would include officials from the Ministries of Finance and Economy & Trade and which would be headed by an official designated as Secretary to the Board. The executive arm would service the Board and be responsible for executing its decisions.

Critical to the success and credibility of the Securities Regulatory Board would be the appointment of the right persons to the key positions of Chairman and Secretary.

D. Conclusions

To summarize, we strongly recommend as a matter of priority that

(1) a Palestinian Securities Law be developed;

(2) a new Palestinian Company Law be developed;

(3) a Securities Regulator be established to administer and enforce the proposed Securities Law with the objectives and functions outlined; and

(4) that resident advisors be commissioned to lead in the undertaking of each of these three technical assistance tasks.

E. Recommendations for USAID Technical Assistance

Training. Serious training needs exist, understandably, throughout the Government and the securities industry. Most of these needs can be addressed through workshops, seminars and lectures presented by the recommended Securities Regulator Resident Advisor (see below). The marginal cost of this training would be small, since the training would be conducted by the "Resident Advisor".

Additionally, executives of the PSE (in particular the Heads of the Departments of Operations & Surveillance, Systems & Technology, Listing & Membership and Clearing & Settlement) should spend short periods at leading overseas exchanges such as New York and/or London. Particularly beneficial would be attendance at one of the US SEC's courses for emerging capital markets. The only costs for participation would be travel and per diem.

Resident Advisor (Securities Law). The Palestinian Territories lack the capacity to independently develop a Securities Law that will meet internationally accepted standards. A Resident Advisor should be appointed to this end. The counterparts for this advisor would be the Minister of Finance for policy input and the Minister of Justice for drafting and legislative process.

The Resident Advisor should ideally be an accomplished legislative draftsman who specializes in securities legislation and who has substantial experience in emerging securities markets. He/She would work in tandem with senior officials from the Ministries of Finance (re policy) and Justice (re local law, drafting and the legislative process).

It should be kept in mind that the framework Securities Law will need to be "enacted" by the Legislative Council (and then subject to the approval of the President), whereas the supporting

Regulations will be made by the Minister of Finance under enabling powers contained in the Securities Law. The main Securities Regulations required will be those relating to Licensing, Conduct of Business, Financial & Accounting Requirements for Licensees, Prospectus, Continuing Disclosure Obligation of Issuers, Advertising, Investment Funds, Financial Resources Requirements and Takeovers.

Phases of Securities Law Technical Assistance:

1. Agreeing on detailed drafting instructions

2. Initial drafting: Securities Law and Securities Regulations

3. Distribution of initial draft of Securities Law (period for internal consideration, e.g. 2 weeks)

4. Distribution of initial drafts of Securities Regulations (period for internal consideration, e.g. 3 weeks)

5. Joint team discussion of initial draft of Securities Law

6. Joint team discussion of initial drafts of Securities Regulations

7. Revising draft of Securities Law in light of team agreement

8. Revising drafts of Securities Regulations in light of team agreement

9. Period for consultation of revised drafts with outside parties as determined by the Minister of Finance (e.g. 4 weeks)

10. Submission of draft Securities Law by Minister of Finance to Cabinet for their consideration

11. Submission by Government of draft Securities Law to Legislative Council for their consideration, and approval by President

12. Upon enactment of Securities Law, making of Securities Regulations by Minister of Finance

Level of Effort for Technical Assistance. Assisting in the above tasks would require at least six person-months of short-term assistance, over a one-year period. Cost summaries for the recommended Securities Law and Company Law advisors can be found immediately following the Executive Summary of this report.

Resident Advisor (Company Law). Although there is not the same critical need for an expatriate advisor to help in developing a modern and unified Company Law, the direct involvement of an international specialist in preparation of a Company Law will provide the added expertise and initiative necessary to conduct the intervention satisfactorily, in a reasonable time period. Therefore the services of a short-term expatriate advisor should be utilized. The counterparts for this advisor would be the Minister of Finance, the Minister of Economy & Trade and the Minister of Justice for company law policy, drafting and legislative process.

Ideally, this short term advisor should be an accomplished legislative draftsman who specializes in company law and who has substantial experience in developing countries. He/She would work together with designated senior officials from the Ministries of Economy & Trade and Justice.

Phases of Company Law Technical Assistance. The draft Company Law will need to be submitted to the Legislative Council for approval and then to the President for signature. An early decision will need to be taken, in consultation with the Advisor, whether a wholly new Company Law should be developed, or whether the existing British Mandatory Companies Ordinance of 1929 should be retained as the basis for a revised, revamped and amplified Company Law. Steps to enactment and implementation, then, include the following:

1. Agreeing on detailed drafting instructions (including determination of whether a wholly new Company Law is required)
2. Initial drafting (assuming new Company Law)
3. Distribution of initial draft to interested parties (period for internal consideration e.g., 4 weeks)
4. Joint team discussion of initial draft
5. Revision of draft in light of team agreement
6. Period for consultation of team finalized draft with outside parties determined by counter-parties (e.g. 6 weeks)

7. Submission of draft Company Law by Minister of Economy & Trade to Cabinet for their consideration and approval
8. Submission by Government of draft Company Law to Legislative Council for their consideration and approval by the President

Level of Effort for Company Law Technical Assistance. Assistance with the above tasks would require at least five person-months of short-term assistance, over a one-year period. Cost summaries for the recommended Securities Law and Company Law advisors are presented immediately following the Executive Summary of this report.

Resident Advisor (Securities Regulator). The need for a Resident Advisor is clear. His/Her role will be to assist in the establishment of the Regulatory body, to develop an Organization Structure (such as Intermediaries Division (Licensing and Supervision), Supervision of Markets Division, Corporate Finance Division, Enforcement Division and Secretariat) and to define their respective roles, powers and duties. The Resident Advisor should also play a major role in assisting with development of the Securities Law and the supporting Securities Regulations. The Resident Advisor would be responsible for the training of the members of the Securities Regulator and the officials forming its executive arm.

Level of Effort for Securities Regulator Technical Assistance. Assistance in these tasks would require a total of twelve months of short-term assistance, over a 15-month period. A cost summary is presented immediately following the Executive Summary of this report.

Potential for Combining Advisors' Roles. The work of the three suggested Advisors can, and indeed should, proceed in parallel. It may also appear that the roles of the Resident Advisor (Securities Law) and Resident Advisor (Securities Regulator) could be combined in one individual with a consequent material reduction in cost. However, the resulting saving would probably not compensate for the risk that one or both of the advising tasks would be compromised, delayed or less ably carried out.

F. References for Developing Securities Market Regulation in the WBG

USAID "Assessment of Legal and Regulatory Policies constraining Business Activities in Gaza and the West Bank" (MSI October 1996);

World Bank Report (Paula Pettunen) entitled "Recommendations on a Securities Market Regulatory and Supervisory Structure for West Bank and Gaza" (14 January 1997);

UNSCO Quarterly Report (Winter-Spring 1997) on "Economic and Social Conditions in the West Bank and Gaza Strip" (1 April 1997);

Draft Securities Market Law of Palestine (prepared for the Palestine Securities Exchange by Canadian Consultants dated February 1996);

Agreement dated 7 November 1996 between the Palestinian Authority and the Palestine Securities Exchange Company Ltd for the operation and supervision of the Palestine Securities Exchange;

Proposed Concept and Regulatory Framework for the Palestine Securities Exchange;

Constitution of the Palestine Securities Exchange;

Membership Rules of the Palestine Securities Exchange;

Listing Regulations of the Palestine Securities Exchange;

"The Legal Structure for Foreign Investment in the West Bank and the Gaza Strip" (dated October 1994, IPCR1 Commercial Law Reports Series);

"A Critical Analysis of the Palestinian Law on the Encouragement of Investment" (dated December 1995, IPCRI Commercial Law Reports Series);

The British Mandatory Companies Ordinance of 1929 (as subsequently amended)(applicable in Gaza);

The Jordanian Companies' Law of 1964 (applicable in the West Bank);

"Legal Aspects of doing Business in Palestine" (October, 1995 by Mazen E. Qupty and Associates, Attorneys);

The Jordanian Securities Law of 1997; so-called draft New Palestinian Company Law (prepared by the Adam Smith Institute - this is not a draft but is merely a commentary and wholly incomplete).

II. Reform of Pensions and Insurance in the Palestinian Territories

Introduction

A major source of long-term capital formation in developed economies is the investment reserves in funded pension plans and the reserves of insurance companies. In order to properly develop these sources of capital in emerging economies, certain statutory and regulatory controls must be in place. These are not yet in place in the Palestinian Territories. Only if pension and insurance plans are prudently regulated and managed will they become sources of much-needed, long-term investment in the domestic economy.

It follows that in considering the potential for equity market funds that might emanate from insurance and pensions, the emphasis must be on the word *potential*. It is possible to consider the capital formation aspects of insurance and pensions only after the soundness of the institutions has been assured. The near term emphasis must be on strengthening the regulatory structure governing existing public and private pension and insurance institutions. Also important are the policy steps necessary to help enable the PA to assume control of Palestinian worker pension funds that currently reside with the Israeli Government.

The economy of the Palestinian Territories is emerging, and now is the appropriate time for carefully designed laws, regulations, and policies to be implemented to encourage the growth of these two sectors. In addition to controls to protect the property rights of these funds as investors, both the pension and insurance sectors require protections for persons contributing to pension schemes or buying insurance policies.

Pensions. In addition to promulgating laws and fund regulations requiring fiduciary responsibility in the PA, it is desirable to help build private sector pension funds to serve a range of employers. Such funds may include employer cooperatives or Government sanctioned funds for small employers and the self-employed, as well as larger employers who do not want to maintain a separate pension fund for their company.

Currently, there are no existing multi-employer pension funds in the Palestinian territories. However, there are three potential sources of funds to begin pension schemes when the proper legal and regulatory mechanisms are in place:

- Provident funds established by the multi-national NGOs and a few of the larger employers;
- Pension deductions currently being withheld by the Government of Israel from Palestinian workers employed in Israel; and
- Termination benefits, probably the largest of the three potential sources.

Insurance. The insurance sector appears at this time to provide less potential than does the pension sector for long term capital formation. There are currently five insurance companies operating within the territory and their focus is primarily property and casualty insurance with emphasis on automobile policies and liability against bodily injury. The market for life insurance is minimal, and there appear to be historical and cultural barriers to the full development of a life insurance industry in the Western sense.

A lack of marketing experience and the relative unfamiliarity of the population with various savings mechanisms also represent major constraints. At the same time, since insurance companies have invested their reserves primarily in property or in financial assets outside the country, there could be a substantial capital inflow if domestic assets were to become competitive in return and risk versus foreign assets.

The MOF has appointed a prominent lawyer as the Insurance Regulator, and this individual was very open to the possibility of on-site assistance for his staff as well as expert review and comment on the draft regulations at the appropriate time. Creation of a regulatory body to include industry representatives and the planning for agent licensing should begin as soon as possible. Assistance in regulation and implementation of appropriate controls should help to guard against the kinds of unscrupulous schemes in the insurance/savings area that have arisen in certain other developing economies. With proper controls in place, the market will attract more players and competition will bring about operating efficiencies and growth.

Recommendations. Now is the time to carefully design laws, regulations, and policies to encourage the growth of both the Pensions and Insurance sectors in order to provide a source of much needed long term investment in the WBG economy. Accordingly, USAID can assist by providing advisors to assist with regulation, actuarial design and pension fund management at the Ministry of Finance. With respect to insurance, technical assistance can be limited to short-term assistance for the insurance regulator who is himself a part-time consultant to the Ministry, and a full-time private sector lawyer.

A. Institutional Arrangements Governing Public Pensions

Pension policies range from fully funded, privately administered, defined contribution schemes (such as in Chile) to more socially oriented pay-as-you-go defined benefit schemes (such as in western Europe). No one scheme can be defined as best for an individual country, but the various options should be explored to determine the scheme which best fits the economic, social, demographic, and cultural needs of the West Bank and Gaza at this time and for the future.

The only existing analysis of pension schemes in the PA is contained in the report entitled *West Bank and Gaza Strip: Pension Reform Issues for the Palestinian Authority* prepared recently for the IMF. This report focuses on pensions in the public or government sector. The IMF report has recently been released to the government for review and it provides the only context in which many officials can comment on the pension sector. Still, there is a need to consider the compatibility of government pension systems with any private pension policy in terms of the potential impact on future labor mobility and related pay and benefits comparability issues. Both government and private pension policy makers can benefit from the provision of USAID technical assistance for this sector. Moreover, policy makers and outside experts for public and private sector pension programs may be the same individuals in some cases. Thus, it is worth briefly examining some of the findings of the IMF report.

Government Pensions. The IMF report recommends consolidating the three very different existing government pensions schemes under one administrator and a coordinated government pension plan. This government plan would be a partially funded defined benefit scheme. In order to finance the transition to this scheme the report proposes using reserve funds from the one existing funded scheme (Gaza Pension Plan) as a bridge until the newly consolidated schemes could become self supporting around the year 2005. Members of the Gaza scheme would be issued some form of government certificate to guarantee that these funds would be repaid.

Several of the parties interviewed expressed concerns about the proposals appearing in the IMF report but all agreed that time would be needed to fully digest and discuss the report before action is taken. In the meantime, roughly $250 million in Gaza Pension Fund reserves are safely residing off-shore.

B. Technical Assistance for Government Pension Policies

Because of the concerns registered about the recommendations in the IMF report it may be useful to allocate some assistance to the government in further discussing this report and in costing out any proposed alternatives. This would mean stationing a person experienced in pension reform/design in the Ministry of Finance to assist with planning and designing various alternatives. Such a person should be recruited as soon as possible to become familiar with the issues and to organize a one or two day discussion seminar with experts in the field to help the responsible parties arrive at positions.

The MOF will also need to acquire the services of an actuary or an actuarial firm to provide valid cost estimates for various scenarios. Since this same expertise will be needed later on it may be wise to contract with a firm and also to begin immediately to select one or two persons to begin actuarial training for the PA. These could either be government employees or recruits who have sufficient math skills to be candidates.

Costs of recommended pension design and actuarial assistance appear immediately following the Executive Summary to this Report.

It would also be desirable to provide assistance to the MOF (Pension General Corporation) in the management of the reserves currently being held in a Swiss bank account to obtain a market rate of return. If the IMF report is accepted these funds will diminish over the next several years, but much would still be gained by investing the funds in higher yielding instruments. If the IMF report recommendations are modified, it is possible that this $250 million dollar fund would continue to grow and thus create a need for substantial assistance in fund management. In either case there will be a need to construct guidelines for investment of pension funds in the private sector. Engaging an experienced pension fund manager and if possible a person experienced in designing guidelines for pension fund management (individuals exist who possess both regulatory and fund management skills) would be extremely helpful. Considering the current market situation in WBG, it would be important to find a seasoned advisor who can help provide an optimal risk-adjusted investment return.

Estimated costs for fund management assistance appear immediately following the Executive Summary to this Report.

C. Institutional Arrangements, Actual and Potential for Private Pensions

There are no existing multi-employer pension funds in the Palestinian territories. However, there are three potential sources of funds to create the foundation for pension schemes once the proper legal and regulatory mechanisms are in place:

- ♦ Provident funds under NGOs and a few large Palestinian firms,
- ♦ Pension funds covering Palestinian workers by the Israeli Government,
- ♦ Termination benefits.

Each of these are reviewed in the following paragraphs.

Provident funds. The multinational NGOs and a few of the larger employers have established a form of Provident Fund for their employees. It was estimated (but not verified) that there could be as much as $50 million accumulated in these funds. Because some progressive employers are already providing Provident Funds for their employees it would be prudent to build on this experience and to begin by utilizing the experience of current plans and international experience to design a pension regulation. Mandatory participation could come after further discussions and might be phased in by size of employer as has been done successfully in many countries.

Israeli Government pension funds. A second potential source of capital exists in the form of pension deductions currently being withheld by the Government of Israel from the compensation of Palestinian workers employed in Israel. (The MOF estimated that $2 billion in arrears are owed to the PA. Using conservative estimates, 50,000 workers making 2000 NIS per month would yield 5 million NIS per month in deductions at a level of 10%.) An existing Protocol provides for these deductions to be transferred to the PA only after a pension fund has been established and sufficient basis established to ensure against liabilities for pension rights being claimed against Israel. This potential accumulation and the related tension over the lack of payment to the PA by Israel make this area a priority for pension design. It is certain that the funds in question will not be remitted until such time as an acceptable legal and regulatory framework has been established and implemented.

Termination Benefits. The third and perhaps richest potential source of capital formation derives from the area of Termination Benefits. Current law and practice require that all workers be granted a termination benefit equal to one month's pay for each year worked (or a similar formula). A unanimous opinion was voiced that these benefits are always honored, but that employers do not reserve these funds (except in rare instances), but rather pay them on a current cost basis. There is no *enforced* requirement to reserve the funds. The Labor Code which has been drafted and is currently under review will harmonize these benefits among the territories.

With proper enforcement and tax incentives, employers could be required to set these monies aside on an accrual basis and thus begin the foundation of a rudimentary pension scheme. In addition to proper Trust Laws and fund regulations there would likely be the need to build employer cooperatives or Government sanctioned and approved Pension Funds for small employers and the self-employed as well as larger employers who do not want to maintain a separate pension fund for their company.

D. Technical Assistance for Private Pension Policies

Design of pension policies in both the public and private sectors would benefit from study tours by pertinent staff in their actual fields of expertise. Training in actuarial science could begin immediately, as the need for such expertise will exist in both the public and private sectors, and effective training may take considerable time. Other specialized training can most likely await design decisions.

In the meantime, as noted above, the MOF would benefit from international expertise to evaluate the comments on the IMF report and from seminars to discuss the pros and cons of various policy alternatives. The Ministry would also benefit from on-site technical assistance during the actual design and implementation of the program. Finally, training and assistance in fund management would be needed if broader investment is to occur. The costs of such assistance are included in the government pension sector technical advice which was outlined above.

Steering Committee. In the private pension sector the Minister of Labor and the Minister of Finance plan to establish a Steering Committee to oversee the development of a coordinated approach to this sector. The degree of cooperation between these two ministries in this area is positive and should be encouraged to continue. The Committee will include persons from these and other ministries as appropriate, as well as representatives of unions, employers, and the banking and insurance sectors. Local lawyers or law firms with relevant experience should also be involved in order to assure that any eventual laws and regulations will be compatible with existing business law and practice.

The Steering Committee will first produce a discussion draft to be followed by discussions within the government and then a draft for public comment. Public discussions would be followed by drafting of necessary regulatory and statutory documents for presentation to the Legislative Council.

Recommendations for Private Sector Pension Assistance

Initial Seminar. In order to initiate the work of the steering committee there should be a seminar for all participants to discuss alternative methods of providing pension coverage and some of the advantages and disadvantages of the various approaches. Advanced reading material should be supplied to acquaint the participants with the basic subject beforehand and to put it in a WBG perspective. This seminar will provide the opportunity for all of the Steering Committee members to start the process with a somewhat equal understanding of the basic principles of pension programs.

Local Lawyer or Organization. As a prelude to the Steering Committee it would also be helpful to contract for a local lawyer or organization to compile and summarize existing pension and related laws and to have them translated for the sake of outside experts where appropriate.

In addition to outside expert advice described below, it would be valuable to contract with a locally qualified law firm(s) to examine proposed policies in light of existing laws.

Expatriate Technical Assistance. On-site assistance from a knowledgeable international pension design expert and a person experienced in pension administration would be helpful from the outset, along with actuarial advice from time to time.

Continuing Seminars, Study Tours and On-Site Training. The conceptual and design phase is likely to require an extended period - perhaps up to two years. During this time it would be most helpful to convene periodic seminars to discuss issues and concepts as well as experiences of other relevant countries. Short seminars held locally with maximum local participation are the recommended course of action during this phase. Study tours for relevant officials would be appropriate after more progress has been made. Finally, training of staff and on-site technical assistance in fund administration and investment management would occur toward the completion of the project. Such training could occur in conjunction with training provided for the government pension sector.

In summary, the following kinds of assistance should be considered in the private pension area:

- Design/produce reading material for initial seminar
- Conduct initial seminar

- Conduct additional seminars
- On site technical assistance
- Assist in drafting regulation/statute

Cost of recommended advisors are presented immediately following the Executive Summary section of this report. In addition, pending availability of funds, the Mission may wish to consider study tours abroad for relevant personnel.

E. Private Insurance and Investment Potential

The insurance sector appears at this time to provide less potential for long-term capital formation than the pension sector. There are currently five insurance companies operating within the territory and their focus is primarily property and casualty, with emphasis on automobile policies and liability against bodily injury.

The life insurance industry is minimal and there appear to be some historical and cultural barriers to the full development of a life insurance industry in the Western sense. As related to us by a prominent Gaza attorney, the extended family provides much of the support that Western societies derive from insurance following the death of a parent, and furthermore, as discussed in the section on trust law, there are Islamic restrictions on the extent to which a bequestor can assign his estate to an individual other than immediate family.

Limitations also exist stemming from limited marketing experience and the relative unfamiliarity of the population with various savings mechanisms. For the most part, insurance companies have invested reserves in either property or financial assets held outside the country.

Regulatory issues. The MOF has appointed a prominent lawyer as the Insurance Regulator. The Regulator operates on a part-time basis with a few full-time staff assigned to carry out licensing reviews and supervision and compliance activities. There is a draft regulation currently being circulated within the Ministry but it is not yet available for review.

On the surface it appears that efforts to date could form the basis for establishing a private sector pension authority in the future. However, it is important to give technical assistance to the Regulator as soon as possible to establish the structure and process for initial licensing and on-going compliance reviews. It is also important to provide for a Regulatory Board or other such entity to ensure that licensing and regulation involves the industry and is shielded from the potential for corruption or excessive political involvement.

It was reported that at least one company had been licensed after rejection by the Insurance Regulator and that this company is not properly funded. All of the large indigenous companies complained that this new company was providing insurance at such a discount that it caused all of them to lose money last year to remain competitive in the market. If this company or others is not properly funded it could cause irreparable damage to the insurance industry and losses to policy holders when claims cannot be paid. It was also alleged that it is not possible for the Insurance Regulator to examine the reserves of the non-WBG based companies since they are not required to keep all of their reserves within the territory. While some of these assertions may reflect resentment toward these new non-WBG companies entering the market, they are serious assertions and should be investigated and resolved quickly.

The Insurance Regulator also manages the Personal Injury Liability Fund and has carefully managed the $20 million transferred to the fund to cover liability for past accidents. Assistance is needed to ensure that adequate reserves are programmed to cover future personal injury claims.

Notwithstanding the social and cultural barriers described above, a relatively active life insurance industry may well emerge over time, following growth in personal income. The PA should move to develop a mechanism for licensing agents prior to any attempt to encourage the growth of the life insurance industry. Assistance in regulation and proper controls should help to guard against unscrupulous schemes in the insurance/savings area such as those which have arisen in certain other developing economies. With proper controls in place the market will attract more players and competition will bring about efficiencies and growth.

F. Technical Assistance to Insurance Regulation

The Insurance Regulator would welcome on-site assistance for his staff as well as expert review and comment on the draft regulation at the appropriate time. Creation of a regulatory body to include industry representatives and the planning for agent licensing should begin as soon as possible. Investigation of the proper funding of existing firms would be the first priority. There is also a need to hold seminars and training for the business community and labor unions. Thus, USAID could consider assistance in the following areas:

- Review of existing draft regulations and advice for improvement
- On site specialist for review and compliance
- Actuarial assistance to estimate reserves
- Assistance to design and implement a Regulatory Body
- Design and conduct seminars

Cost summaries for recommended assistance are presented immediately following the Executive Summary section of this report.

G. Conclusions

The appropriate focus for technical assistance in public and private pensions in the Palestinian Territories at this stage must be on establishing the proper regulatory structure. Adoption of acceptable regulation could lead to near term benefits, including payment by the Israeli Government of substantial funds that currently are held in trust for Palestinian workers. This would directly support USAID's objective of increasing capital flows to WBG. As a whole, the proposed interventions specified by USAID in Annex 1 to the SOW for this project appear appropriate.

The potential capital flows from this sector will not be realized until credible regulatory control is implemented and well-known current deficiencies in reserve management are corrected. As noted, there is somewhat less potential for long-term investments from the life insurance sector, because of cultural or historical restrictions on the use of this form of insurance. Still, the potential from contract saving is substantial given the saving flows discussed in the introduction to this report.

Consequently, the technical assistance recommended for the insurance sector is consistent with Annex 1 to the SOW, but somewhat more conservative than the Insurance sector reform interventions suggested in the Insurance Sector Reform section of the Concept Paper (I.R.1.4, pp.7-8). At this time, contract savings proposals should be left for consideration until after the proposed ministerial steering committee has settled on prudent and enforceable regulation, licensing and oversight.

III. Implementing International Accounting and Auditing Standards in the Palestinian Territories

Introduction

Currently, in the West Bank and Gaza there are neither enforceable accounting standards for financial statements nor licensing standards for the accounting profession. As a result, financial statements do not provide the transparency needed for sensible and efficient investment analysis. Requiring the application of generally accepted principles of accounting and auditing in the preparation and examination of financial statements would stimulate equity investments in at least two important ways. First, their application would substantially improve the availability and reliability of information made available to major players: investors, markets, and regulators. Second, it would increase investor confidence in the security of contracts by providing feedback on management's stewardship of the resources entrusted to them.

Because financial information is more reliable, given the imposition of standards, and obtained at lower cost than in their absence, investment decisions becomes less costly and less risky: less costly due to the ease of obtaining reliable information; and less risky because of the greater information about, and comparability of, capital assets. The reduction in risk reduces the rate of return that is necessary to stimulate investment. So, the implementation of standards and resulting increase in financial transparency directly improves the attractiveness and liquidity of investment assets and the efficiency of capital markets.

Largely due to major efforts undertaken by the International Accounting Standards Committee (IASC) and the International Federation of Accountants (IFAC), financial transparency and investor confidence have been increased by harmonizing accounting and auditing standards worldwide. And, international standards of accounting and auditing serve as benchmarks for developing economies such as the Palestinian Territories, in the process of forging their own requirements.

Consequently, and also given aspirations to membership in the International Organization of Securities Commissions (IOSCO), the Palestinian Territories development should include in their financial markets regulatory legislation provisions to the effect that financial information filed with the regulatory body, as well as the Securities Exchange and other institutions as appropriate, should be prepared in accordance with international accounting standards (International GAAP) and audited in accordance with international auditing standards (International GAAS).

Recommendations. Implementing international accounting and auditing standards in the Palestinian Territories requires efforts on four fronts:

- Reporting: companies must be subject to enforceable legislation that embodies these standards;
- Professionalism: accountants and auditors must demonstrate the requisite skills to apply the standards, and assist companies in their lawful compliance, as members of a registered, professional association;
- Regulating: oversight of the registered professional body should govern professional admission standards, continuing professional education requirements (CPE), and sanctions for unprofessional behavior; and
- Professional Training: educational and training institutions must be adequate to ensure and maintain the flow of practitioners with the requisite skills.

USAID can make contributions in these areas through providing technical assistance in:

- Establishing a broadly representative Accounting Standards Board
- Establishing a self-regulatory professional accountancy body
- Assisting with continuing professional education in international accounting standards for chief accounting and financial officers, as well as senior accounting and finance technicians
- Assisting with training in international standards and auditing, for professional accountants and their staff
- Establishing a framework for setting accounting standards, and the registration and registration of the accounting profession, at the Ministry of Finance and the Palestinian Association of Accountants.

Recommendations in the areas of securities regulation and financial market regulatory statutes are contained elsewhere in this report. The legal mechanisms for establishing GAAP and GAAS as well as the two remaining requirements concerning professional standards are the focus of this section.

A. The Status of Private Sector Accounting and Auditing Standards in the Palestinian Authority

Legal mechanisms for establishing GAAP and GAAS. At present, there are no comprehensive and congruent sets of accounting and auditing standards in the Palestinian Authority as a whole. Nor are there legal mechanisms in place to establish such standards. As a result, the divergence of financial reporting and auditing practices produces financial statements which may not be consistent from one period to another, or comparable with other companies in the same industry, and therefore do not provide the credibility required by financial markets.

This situation is the result of political events and territorial redistributions which took place following 1948. Until that time, the British Mandate's Company Law of 1929, as amended through 1934, applied to both Gaza and the West Bank. While this law still applies in Gaza, after 1948 accounting and auditing for companies in the West Bank became subject to Jordanian regulations - in particular, Law No. 10 of 1961, governing the practice of auditing, and Law No. 12 of 1964, governing company accounts. The relevant sections of these laws are excerpted in Appendix 1. Both sets of legislation are inadequate for modern business conditions and accounting practices.

It follows that businesses as well as professional accountants and auditors have to make interpretations and adaptations of regulations on an *ad hoc* and individual basis. The situation is further complicated by the flexibility of the laws which have governed the licensing of professional auditors (refer to appendix 1 for the full text of relevant sections). Some degree of stability may be found in the West Bank, however, where five multinationally-affiliated accounting firms have established a presence. These firms follow international standards of accounting and auditing supplemented, as needed, by U.S. standards.

To provide a very limited example of the variation in the quality of financial reporting which currently exists, a comparison between the auditors' reports for Arab Bank Plc and the Bank of Palestine Ltd is presented in Appendix 5. The former report was prepared in accordance with international accounting and auditing standards by an affiliate of a multinational accounting firm. The latter report was prepared by a firm located in the West Bank and contains the following summarized, significant departures from international standards. (Further details are provided in Appendix 5.) This is a matter of particular concern because the Bank of Palestine is registered with the Palestine Securities Exchange although its shares have not been traded.

The opening paragraph of the report:

- Does not identify the financial statements audited;
- Does not contain a statement of the responsibility of the entity's management and the responsibility of the auditor;
- Combines the scope paragraph, which describes the nature of an audit, with the introductory paragraph. The last two sentences of the first paragraph should constitute the second, that is scope, paragraph.

♦ The scope section (last two sentences of opening paragraph) of the report does not adequately describe the work the auditor performed.

♦ The report fails to explain or elaborate on a departure from the historical cost convention.

♦ The report fails to comment on the lack of a cash flow statement as required by International Accounting Standard 7.

♦ The report fails, without reference or explanation, to express an opinion on the financial statements. This is, or should be, the main purpose of the auditor's report.

Further, the Bank of Palestine's annual report for 1996 does not contain any notes to the financial statements as required by various International Accounting Standards, including IAS 1: Disclosure of Accounting Policies; and IAS 30, Disclosures in the Financial Statements of Banks and Similar Institutions. The absence of a cash flow statement, required by IAS 7, is noted in item 4 above.

The problem of the lack of uniformity and consistency in accounting and auditing principles and practices is exacerbated by the absence of both a standards-setting body as well as an officially recognized professional accountancy body (the latter topic is covered more fully in the following section). Thus there are no mechanisms in place for the promulgation, with due process, of internationally accepted accounting and auditing standards of accountants (IFAC).

B. Recommendations for Technical Assistance in Establishing International Accounting Standards

A broadly representative Accounting Standards Board should be established which will promulgate internationally accepted accounting standards through an open system of due process. The Palestinian Institute of Accountants, reconstituted, officially registered, and regulated, should play a major role in the standard-setting process.

USAID can make a significant contribution to this effort by providing a full-time advisor to the Deputy Minister of Finance to assist in the elaboration of a draft regulation to establish an accounting standards-setting body as well as its implementation in practice. The Deputy Minister has expressed a need for this type of assistance and has stated his willingness cooperate with such a specialist.

The Deputy Minister of Finance has already retained a consultant, a lawyer specializing in Jordanian fiscal law, to commence drafting proposed standard-setting legislation and hopes to have a working copy available during the next two to three months. It is therefore important that a specialist with broad technical experience in the setting of international accounting standards be made available at an early date.

C. Status of the Accounting and Auditing Profession in the Palestinian Authority

There is presently no officially recognized professional institute of accountants in the Palestinian Authority. Two Palestinian Associations of Accountants exist: one in Gaza, the other in the West Bank, and each has unsuccessfully applied to the PA authorities for official recognition by registration. The official policy is, however, that only one combined body from both geographical locations will be registered.

The two Associations of Accountants, in Gaza and the West Bank respectively, have reached a general understanding about the institutional arrangements for a merger. This would provide official recognition and registration, and would include the possibility of adapting features from recent Jordanian regulations.

One of the major issues to be dealt with has to do with the disparate sets of professional qualifications existing in Gaza versus the West Bank. The qualifications for an auditor to practice in Gaza, as enumerated in Section 105, Chapter 22, of the Company Law (Palestine Ordinance No. 18) of 1929 amended through 1934, which is still in force, are as follows:

"105. (4) No person shall be capable of being appointed auditor of a company unless he is properly qualified by certificate from some university or other institution approved by the High Commissioner for the purpose, or by membership of some society of accountants or auditors, approved as aforesaid, or unless he has obtained from the Government of Palestine a certificate entitling him to practice in Palestine as an auditor." (Refer to Appendix 1 for more complete text.)

In the West Bank, on the other hand, the requirements for professional qualifications, contained in Law No. 10 of 1961 governing the practice of auditing, are more specific and rigorous.(Refer to Appendix 1 for more complete text.) In accordance with article 3, any one of the following qualifications must be met in order to be licensed:

(a) membership in, and licensed by, American or British Institutes of Certified Public Accountants;
(b) holder of a Bachelor's degree in commerce, economics, or finance from a university or other institution of higher education plus experience in government, or in an accounting office in the Palestinian Territories, of which not less than one year as a senior auditor or audit manager. A certificate of experience should be submitted to the certifying committee for approval;
(c) a high school diploma, or its equivalent, plus four years' experience as an audit senior or manager in a governmental or specialized audit office, or in the office of a public accountant authorized to practice in Palestinian Territories;
(d) in the absence of a high school diploma, full-time practice of auditing with a minimum of six years' experience as a senior auditor in a governmental or professional accounting office. (A "grandfather" provision for auditors who have not completed high school.)

Article 4 sets out the additional requirements of national citizenship, a minimum age of 25 years, and no criminal record or indictments for ethics violations.

Article 5 eases the requirements of article 3 in two ways:

- ♦ It provides an additional “grandfather” provision by allowing an exemption for those who have been in professional practice in Jordan for at least two years prior to the inception of the 1961 law; and

- ♦ It permits foreigners to practice as auditors if their country of origin grants reciprocity to those auditors licensed in Jordan.

Thus, the approximately 2,000 registered auditors from Gaza, who outnumber those in the West Bank by about ten to one, will , in the main, have a lower level of professional competence. Differences in competencies have, however, been taken into account in the arrangements for a merged Professional Association which are under consideration and which may borrow the following features of the Jordanian approach, perhaps with modifications to fit local circumstances and needs. (Refer to Appendix 2 for additional details of financial reporting and auditing in Jordan.)

In Jordan, the three essential elements of professional status - education, experience, and examination - are recognized in the professional licensing provisions. Only auditors licensed by the Accounting Professional Council are authorized to sign audit reports. These auditors are classified into three categories - A,B and C - according to their relative educational qualifications, as well as experience:

A. **Category A** auditors have a university degree in accounting and a minimum of three years' experience, of which one year is in public accounting. They alone are permitted to audit banks and public shareholding companies;

B. **Category B** auditors have a university degree in business or law with a minimum of five years' experience, of which one year is in public accounting;

C. **Category C** auditors are all other auditors.

In order to become a licensed auditor, the applicant must also pass an examination. Exceptions are made for Jordanians holding major recognized accounting qualifications, usually from the United Kingdom or the United States, who, at the Council's discretion, may be granted membership without sitting for the examination.

In summary, the only professional auditors who can perform the attest function in the Palestinian Authority in accordance with international auditing standards are those relatively few individuals who meet IFAC's professional competency guidelines. It is therefore recognized that a significant amount of training will be necessary to upgrade the education, experience, and examination qualifications of professional auditors so as to meet, at the least, the minimum standards recommended by the International Federation of Accountants (IFAC).

D. Recommendations for Technical Assistance in Establishing Professional Standards for Accountants

A self-regulatory professional accountancy body should be established. It should be empowered to assist materially in the promulgation of internationally acceptable accounting and auditing standards and to enforce a professional code of ethics should be established and officially recognized through registration.

Because of the existing variations in competency levels, a sunset clause could “grandfather in”, perhaps for a limited period of time, those members who need continuing professional education in order to meet IFAC's recommended minimum competency requirements.

Given the widely varying levels of skills, accountants could be classified into various categories of competency for performing particular engagements, following the approach taken in Jordan.

USAID could make a significant contribution to this effort by providing a full-time technical advisor to the Deputy Minister of Finance, who is supervising the reconstruction of the institutional arrangements, and the drafting of legislation, governing the accounting and auditing profession.

The Palestinian Institutes of Accountants in Gaza and the West Bank have also requested technical assistance, particularly:

- In their efforts to restructure their organizations into a combined self-regulating body; and
- In designing the arrangements for setting and evaluating entry-level professional qualifications covering education, experience, and examination proficiency.

E. Training Needs of Professional Accountants and Auditors

In order to apply and use international standards of accounting and auditing in performing the attest function in a professional manner, licensed auditors need to:

- Possess the core of knowledge required of all professional accountants; and
- Acquire and maintain the specialized knowledge needed for professional auditors.

The main thrust of training efforts should, therefore, take a two-pronged approach:

- Upgrading the education qualifications of those currently-licensed auditors who do not meet the minimum education requirements identified by IFAC as constituting the core of knowledge of the professional accountant; and

- Providing specialized training in the application and use of international standards of accounting and auditing to those currently-licensed auditors who already possess the minimum education requirements identified by IFAC as constituting the core of knowledge of the professional accountant.

Professional Core of Knowledge Acquisition. The core of knowledge of the professional accountant, as identified by the International Federation of Accountants (IFAC), provides for both core and supportive subjects. It is briefly summarized below (refer to appendix 3 for more complete text):

Core Subjects	Supportive Subjects
Financial Accounting	Economics
Management Accounting	Law
Information Technology	Mathematics & Statistics
Auditing	Behavioral Sciences
Taxation	Management
Business Finance	

IFAC has identified several overall objectives of training for professional accountants (IFAC 1996 Handbook, p. 555):

"One such objective is to provide an understanding of the nature and role of accounting so that the contemporary issues can be judged. This requires a historical perspective of the accounting profession, an ethical perspective, and a theoretical perspective of the other disciplines on which accounting draws, such as economics. Also, the technical training of professional accountants should be such that it develops not only procedural skills, but also skills in judgment, oral and written communication, integrating knowledge from different areas, formulating proposals, identifying important issues, and in distinguishing the relevant from the irrelevant."

A professional core of knowledge is usually acquired in the course of obtaining a diploma with an accounting major at an institution of higher education: in particular, an accredited university. There are several universities in the West Bank, and one in Gaza, which offer such programs and it is generally acknowledged that the accounting degree programs at Bethlehem and Birzeit Universities are among the most highly respected. Their accounting graduates are heavily recruited, particularly by banks, insurance companies, and public accounting firms among others. The accounting major curricula at these universities, detailed in Appendix 4, are taught in English from (usually) American texts and they meet IFAC's minimum requirements.

So, the flow of accountants into the profession, at least from Bethlehem and Birzeit Universities, is of high quality. The biggest need in the West Bank at present, expressed by recruiters, is for middle level personnel with some experience.

It is in Gaza, on the other hand, that there is the most call for basic professional training. The President of the Palestine Association of Accountants in Gaza considers that few, if any, of the 2,000 auditors registered in Gaza have a clear understanding of what the auditing function consists of, let alone understand how to perform it. So, in his opinion, they need to acquire the basic expertise in auditing which constitutes part of the professional core of knowledge, plus practical experience gained through internships, before instruction in the use and application of international standards of accounting and auditing would be beneficial.

Specialized Knowledge Acquisition. Training in specialized topics should concentrate on the use and application of international standards of accounting and auditing for two main reasons:

1. Transparent financial information prepared on the basis of these standards is highly desirable for attracting flows of equity investments to the PA; and

2. Currently-licensed auditors, and those aspiring to professional certification will be motivated to learn: particularly if, as it appears, these standards will be adopted in prospective legislation governing accounting standards, professional certification and regulation, company reporting, and securities listing.

For professional accountants and auditors, such courses could be given in training institutes which are authorized to offer accredited courses in continuing professional education (CPE). The legislation governing professional regulation should contain provisions that a minimum number of accredited CPE hours be required for periodic renewals of the professional license to practice.

Instruction in international accounting standards of accounting should also be made available to chief accountants and financial officers, as well as senior accounting and finance technicians, particularly from those firms which are registering securities for public sale or contemplate doing so at some point in time. This training should substantially improve the quality of information which is provided to the licensed auditor for application and use of international auditing standards when performing the attest function.

According to the director of the professional training center at Bethlehem University, there are numerous training centers in the PA which could be used for giving basic professional education and CPE courses. However, these efforts should be coordinated to make most efficient use of available instructional aids. (One of these aids could include a two-way satellite-connected classroom at Bethlehem University. At present, lecture/discussion sessions are transmitted from France for several hours daily, four days per week. The main cost is the use of the satellite but this is probably more economical than bringing in lecturers physically.) If a large-scale training program were contemplated, the director would recommend that it be designed and supervised by an experienced technical advisor.

The logistics could be challenging because of difficulties in traveling between Gaza and the West Bank. The authorities should facilitate arrangements for West Bank and other instructors to receive permits for travel to Gaza. Also, “training the trainer” programs could be established in accessible neighboring locations. For Gazans, in particular, use of the Arabic language would be required for both oral and written training purposes.

F. Recommendations for Technical Assistance with the Training Needs of Professional Accountants and Auditors

To achieve the levels of competency needed for the application and use of international standards of accounting and auditing, significant continuing professional education training needs exist:

- With respect to international standards of accounting, for chief accounting and financial officers as well as senior accounting and finance technicians, of firms wishing to register securities for public sale; and

- With respect to international standards of both accounting and auditing for professional accountants and their staff, so as to qualify them to perform the attest function for those firms attracting equity investment.

USAID could make a significant contribution to this effort by proving a full-time technical advisor to the Deputy Minister of Finance, who is responsible for overseeing efforts to restructure the mechanisms for accounting-standards setting, organization and registration of the profession, and professional regulation.

Training facilities, as well as Arabic-speaking potential trainers, exist at the present time through the Universities: particularly in the West Bank. However, approved training programs would need to be designed, and Arabic-language versions of the international accounting and auditing standards, as well as other training materials and instructional aids, made available. This effort would require a detailed training program and budget for which a technical advisor, experienced in designing, organizing, and carrying out training programs and workshops, would be responsible.

G. Professional Regulation

The accounting and auditing profession needs regulation in the public interest to assure:

- That properly qualified persons are license to practice as professional accountants and auditors; and

- ♦ That those who are licensed to practice maintain their professional skills by fulfilling defined requirements for continuing professional education.

In the West Bank, the current process of auditor certification follows the provisions of article 7 of the Jordanian Law No. 10 of 1961 which identifies the license granting body as the License Review Board. This Board consists of the following members: the Deputy Minister of Finance (chair), the Deputy Minister of Economy and Trade, the Deputy Auditor General, the Head of the Trade Division in the Ministry of Finance, and a practicing accountant. The decisions of this committee, either unanimously or by a majority, are, however, subject to final approval by the Auditor General.

The Jordanian approach to professional regulation is currently under consideration for adoption in the PA, with adaptations as needed. The accounting profession in Jordan is regulated and controlled by the Accounting Professional Council and the Jordanian Association of Certified Public Accountants. The latter body was created in 1987 and is responsible for issuing accounting standards and ethical standards. It has not yet issued auditing standards. (Refer to Appendix 1 for additional details of accounting and auditing in Jordan.)

Any prospective regulatory body, such as an Accounting Professional Council should, however, have broad public representation and not be almost entirely dominated by government ministries.

H. Recommendations for Professional Regulation

An accountancy profession regulatory mechanism should be established which governs, *inter alia*, professional admission standards (including education, professional licensing examinations and reciprocity), continuing professional education requirements, and sanctions for non-compliance with ethical and professional performance standards.

USAID could make a significant contribution by providing a short-term, full-time technical advisor to the Deputy Minister of Finance. This official is responsible for supervising efforts to reconstruct infrastructure arrangements for accounting standards-setting, and the registration and regulation of the accounting profession.

The Palestinian Associations of Accountants have also requested technical assistance so that they may provide input into the decision-making process regarding professional regulation matters.

I. Conclusions and Recapitulation

Policy Initiatives and Proposed USAID Intervention:

The terms of reference for the accounting and auditing standards specialist are:

- To review proposed interventions to develop uniform and internationally accepted accounting and auditing standards; and
- To help to develop or modify those interventions and provide a level of detail sufficient to allow for implementation to begin in FY 1997.

The proposed interventions, listed below, are drawn from policy initiatives which include the establishment of uniform accounting and auditing standards so as to contribute to market transparency, efficiency, and investor confidence.

- USAID should consider providing short-term, full-time assistance to the Ministry of Finance to develop legally acceptable accounting and auditing standards that are consistent with international practice; and

- USAID consultants should also work with the Palestinian Association of Accountants to help establish a compliance program that could include workshops and on-the-job training.

Our review supports these two basic interventions and suggests modifications in the way of additional measures that would increase the feasibility and effectiveness of USAID action. Briefly stated, these additional interventions relate to:

- The need for a standards-setting body to be established so that legally acceptable accounting and auditing standards can be promulgated;

- The need for a legally recognized, registered, and self-regulating professional institute of accountants to be established which could participate in the accounting standards-setting process;

- The need for training both in specialized topics, such as international standards of accounting and auditing, as well as topics constituting the basic core of knowledge which is required of a professional accountant; and

- The need for an oversight regulatory mechanism to be established which, working in tandem with the officially-recognized professional institute of accountants, would insure compliance with the application and use of international standards of accounting and auditing.

Until these additional infrastructure measures have been taken by the authorities, and the institutions are in place, activities involving USAID consultants in cooperative efforts with Palestinian professional accountants will not be maximally effective.

Recapitulation of our recommendations. Recommendations for USAID interventions, drawn from the preceding sections of the report are recapitulated below.

USAID should consider providing short-term, full-time technical advisors to the Ministry of Finance for the indicated purposes. Because the drafting of proposed legislation for these various initiatives is already underway by a local fiscal law specialist, it is important that specialists with broad technical expertise be made available to the Ministry at an early date.

1. To assist both in the elaboration of a regulation to establish an accounting standards-setting body as well as in its implementation.

2. To assist in the establishment of an officially recognized, registered, and well-trained, self-regulatory professional accountancy body which will be empowered, *inter alia*, 1) to participate materially in the promulgation of internationally acceptable accounting and auditing standards and 2) to enforce a professional code of ethics including standards of professional performance.

Because of the wide variations in levels of skills and competencies among the existing licensed auditors, the technical advisor(s) should consider recommending that the following be considered in making the institutional arrangements:

(a) provision of sunset clause(s) so as to “grandfather in”, possibly for a limited period of time only, those registered auditors who need training in order to meet IFACs recommend minimum competency requirements for professional accountants; and

(b) the classification of accountants into various categories of competency for performing particular engagements, following the approach taken in Jordan.

3. To assist the authorities, in cooperation with the Palestinian Associations of Accountants in the West Bank and Gaza, or the registered body of professional accountants if the two Associations have already been reconstituted, in designing and instituting the arrangements for setting and evaluating entry-level professional qualifications which cover education, experience, and examination proficiency.

4. To direct the design and implementation of a training program of workshops on international standards of accounting, for chief accounting and finance officers, as well as senior accounting and finance technicians, of firms wishing to register securities for public sale.

5. To direct the design and implementation of a training program of workshops on international standards of accounting and auditing for professional accountants, and their staff, so as to qualify them to perform the attest function for those firms attracting equity investment.

6. To assist the Palestinian Associations of Accountants in Gaza and the West Bank, or the registered body of professional accountants if already reconstituted, in:

(a) the design and implementation of classes to upgrade their educational qualifications to as to meet the minimum requirements of the core of knowledge of professional; accountants, as identified by the International Federation of Accountants (IFAC); and

(b) arranging for internships to obtain professional auditing experience for key individuals, identified as potential “trainers” who could subsequently conduct training sessions on practical auditing procedures and processes.

The technical advisor(s) for training should be experienced in designing, organizing, and carrying out training programs and workshops. Trainers would need to be Arabic speakers and use Arabic language training materials.

7. To assist, in cooperation with the authorities, professional accountants and other parties as appropriate, in the establishment of an accountancy profession regulatory mechanism which governs, *inter alia,* professional licensing, professional admission standards (including education, professional licensing examinations and reciprocity), continuing professional education requirements, and sanctions for non-compliance with a code of ethics, including standards of professional performance.

J. List of References for Implementing International Accounting and Auditing Standards in the Palestinian Territories

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IV. Incorporating Professional Ethics in Financial Services Laws of the Palestinian Territories

Introduction

A single, broadly conceived Trust Law for the Palestinian Territories was indicated in USAID's Scope of Work for this assignment. The purpose of such a law would be to assure potential investors that their transactions and investments would be handled with integrity, and that arrangements between investors and financial intermediaries were transparent and reliable. However, USAID's objective can be more directly and efficiently accomplished by the incorporation of fiduciary duties - more accurately, professional ethics - into the laws governing specific professional fields.

The rationale for a Trust Law for the Palestinian Territories would be to enhance investor confidence. The law would accomplish this by requiring that professional representatives and companies handling financial transactions and managing assets are trustworthy and behaving according to ethical norms. USAID, in its proposal for a general Trust Law, sought to ensure that laws regulating financial activities would specify relevant fiduciary duties, and the means to enforce compliance with them.

However, legal safeguards to sustain investor confidence can be provided more effectively and efficiently by including specific fiduciary duties - that is, codes of professional conduct - in existing or planned financial services laws rather than by promulgating the enactment of a single, general "Trust Law."

During the course of this assignment, the term "Trust Law" caused a certain amount of confusion. In light of what is sought by the SOW, the word "trust" is a misnomer.[8] The word "trust" is a rather narrow legal term referring to a specific arrangement embodied in a deed. Given this specificity, it

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A trust is a technical legal term referring to a legal arrangement under which through a deed of trust a trustee is vested with the legal title to the property, the subject of the trust. The trustee is entrusted to manage that property for and on behalf of a beneficiary (who holds an equitable interest in the trust property). The trustee must act in accordance with the terms of the trust and is subject at common law (and sometimes also under a trustee law) to a variety of fiduciary duties.

would be difficult to draft a Trust Law that would suitably cover the contractual arrangements and customs peculiar to each financial services industry to be covered by such a Law.

Thus, standards of professional ethics should be incorporated into existing or new laws appropriate to each regulated financial service: securities markets, pensions and insurance, accounting standards, and company governance. The fiduciary duties or professional ethics to be included in financial services laws would cover honesty and integrity, conflicts of interest, confidentiality, and standards of care and disclosure. Industries covered would include securities markets, pensions and insurance, accounting standards, and company governance. Since the Ministry of Finance will be the counterpart for legislation for the regulation of securities (including company governance aspects), pensions and insurance, and accounting and auditing standards, this ministry should also be the counterpart for these proposed fiduciary law improvements.

Efficiency of enforcement is a further argument for incorporation of fiduciary duties into the various existing or planned financial services laws rather than the enactment of a general Trust Law. A general Trust Law would not focus specifically on particular industries. As a result, its enforcement would be more vague for any given industry than if the law were specific to the industry and, hence, to the regulatory agency for that industry.

Recommendation. The process for incorporating professional ethics into laws regulating the financial services sector should be initiated with a workshop addressing all of the issues and all of the industries to be covered by such standards. This workshop should be held as soon as possible. Workshop participants should include representatives of all of the regulated financial services, the ministries and professional non-government bodies who will regulate them, and members of the PA who will draft the legislation.

Methodology. Arguments in favor of the enactment of a general Trust Law are not contained in this report. Rather, consideration is given to the advantages of introducing industry-specific professional ethical standards into the laws governing each financial service industry.

A. Introducing Enforceable Fiduciary Responsibilities by Building on Existing Law

Fiduciary duties, including professional ethics, should be introduced by building upon laws which have already been enacted. By simply making explicit what should be normal ethical practice, the disruption to commerce would be minimized. Alternatives would require altering the entire regulatory structure, including areas where it is already satisfactory. In areas where a satisfactory body of law does not exist (or, as in the case of Company Law, where there are possible conflicts between different laws in the West Bank and in Gaza), fiduciary duties should be incorporated into proposed legislation covering specific financial services.

Specific rather than general approach. Fiduciary duties should be complemented by other provisions governing the operations of financial intermediaries to ensure transparency, accountability and consumer protection. While most of these are common to all areas of financial activity, the specifics of their application should be written into the laws covering each industry (securities markets, company governance, insurance policies and pension funds, and accounting and auditing practice). Laws regulating each industry can address its specific characteristics, fiduciary duties, problems in practice and peculiarities of client relations or contracting arrangements.

Facilitating enforcement. In general, it is easier to enforce a specific law than a general law. Under a specific law, a single institution holds responsibility for ensuring compliance. Under a general law, no sole institution is responsible for ensuring compliance, as all government entities are called upon to enforce the law within the limits of their purview.

Considering the endemic problems of enforceability in the Palestinian Territories, whenever possible specific laws will be preferable to general laws. In regard to enhancing investor confidence, specific laws will be more stringently enforced and contribute to greater investor confidence that they are, will be and have been ethically served.

Validation of the proposed intervention. Creating a financial environment ensuring that investments are handled with integrity is a precondition for effectively mobilizing equity capital. The current legal structure does not provide sufficient safeguards to give this level of confidence to investors in the Palestinian Territories.

The incorporation of professional ethics into financial services laws would provide mechanisms subjecting all persons and companies engaged in financial intermediation activities to a set of strict rules of conduct. Enforcing these ethical standards would increase transparency in financial markets, promote higher degrees of accountability among both private and public sectors, and protect the interests of customers and the public at large. This is, ultimately, the purpose of the legal framework for regulating financial services - to maintain investors' confidence.

B. Fiduciary Duties and Regulatory Requirements in the Palestinian Territories

The fundamental principle underlying the concept of fiduciary duties is the requirement to act honestly, diligently and in the best interests of the client. The duties listed below are those that are commonly applicable to trustees in most trust arrangements. Of these, three are the most relevant to enhancing the environment for mobilizing equity capital in the Palestinian Territories:

- ♦ The duty to act honestly and fairly in conducting activities, in their clients interest;
- ♦ The duty to avoid conflicts of interest;
- ♦ The duty to apply a high standard of care.

The first is what a client should reasonably be entitled to expect from his financial services professional. For implementing the avoidance-of-conflict-of-interests rule, it is necessary to take into account four common situations where this rule should be observed and enforced. First, financial intermediaries should be required to organize and structure themselves in such a way as to minimize the risk of clients' interests being prejudiced by conflicts of interest between the company and its clients, or among one company's own clients. Second, there should be appropriate regulatory requirements for preventing a financial intermediary institution from using investors' funds for its own account and benefit. Third, there should be rules to restrict the provision of services on more favorable terms to persons related to the institutions' directors, managers and officers than to unrelated clients. A definition of who is deemed to be "*related*" to the financial intermediary will be necessary for the purposes of the conflict of interest rule. Fourth, in the application of the appropriate standard of care, financial intermediaries should be required to observe a higher standard of conduct than is normally requested of a trustee. Being institutions comprised of financial professionals, financial intermediaries must also ensure that their staff is qualified and trained, and that they are performing their duties with appropriate skill and diligence.

C. Additional Requirements Applicable to Financial Intermediaries

The introduction of professional ethics in financial activities will not by itself be enough to ensure that investments are handled with the highest degree of integrity. To maximize their impact, these fiduciary duties need to be complemented by additional requirements imposed on the management, administration and supervision of financial intermediaries in order to protect bank clients, investors, insurance policy holders and pension plan beneficiaries. Synopses of these requirements are presented below.

Disclosure requirements. Institutions engaged in financial intermediation activities should be required to make adequate disclosure of relevant material information for their prospective and current clients. The purpose of this requirement is to furnish potential customers with sufficient information for them to make an informed evaluation of the merits of the services offered. It is important that the regulatory authority determine, for each financial service, the information to be disclosed, the form in which it is to be presented, and the precise time (from the beginning of the transaction) that it is to be made available. The differences in these particulars for each financial service industry substantiates the benefits of enacting distinct fiduciary duties for each industry rather than to seek such ethical rules under a general Trust Law.

In the financial services provided by the securities market, pension funds and insurance activities, disclosure requirements are equally critical. As with financial intermediaries, they allow prospective customers to assess the terms of a transaction they are considering and to verify afterwards the conditions in which it was carried out. However, the substance and form in which information must be made available to the public may be different in each case. Analyses of the information to be disclosed are contained in the first two chapters of this report, while its forms are discussed in the chapter on accounting and auditing standards.

A form of disclosure relating to individuals in the financial services industries is the requirement that newly appointed directors, managers, and high-ranking officials of financial intermediary institutions make a declaration to the Board of Directors or the supervisory authority as to their financial situation, revealing any significant commercial interests in the business of the company that may interfere with the exercise of their responsibilities, and what they intend to do to avoid or resolve this conflict.

Confidentiality of internal information. Just as disclosure requirements are essential to market transparency, confidentiality regarding internal information is generally in the best interest of companies, customers, and the integrity of the market. Thus, officers of financial institutions should be prohibited from disclosing and using for their own benefit - or the benefit of others - key information about the businesses which they have come to know in the course of their work as a result of positions of trust.

Licensing requirements. It is of the utmost importance that the competent authorities establish the requirements for prospective financial intermediaries (both institutions and financial professionals) to practice in the market. Allowing only licensed practitioners to offer services ensures that they are subject to regulatory oversight and discipline. The rules that govern them - professional ethics - ensure market integrity, but only if these requirements are strictly enforced in the granting, renewal and continuance of professional licenses.

Financial reporting. In order to obtain reliable financial information about the market, it is necessary that companies be required to keep records in accordance with international accounting standards (International GAAP). In addition, companies subject to auditing requirements must be compelled to use international auditing standards (International GAAS). Section III of this report has set forth the analysis of these standards and the benefits of their enforcement.

Rules on directors and managers. Rules on directors and officers are intended to ensure that the persons who effectively direct the business of the financial intermediary are of sufficiently adequate repute and sufficiently experienced. These rules deal with the qualifications for being a manager or director in a financial intermediary institution, as well as the procedures for appointment and removal from office. Some jurisdictions may restrict the ability of directors and high ranking officers to perform any other work, related or not to the position they hold in a financial intermediary institution.

Regulation of advertisement. Financial intermediaries offer their services to the public through direct circulars and in media advertisements. It is important that rules be issued to ensure the validity of claims and promises offered in promotional activity by a financial intermediary. Rules in this area should answer the basic questions of what, how and when advertisements can be used, and set forth the rights of customers and the general public to ask for substantiation.

D. Confirmation of Counterpart Agency

Under the implementation mechanism recommended, fiduciary responsibilities should be written into the proposed legislation or amendments eventually drafted to regulate the securities market, insurance companies, pension funds, and accounting/auditing firms. Thus, the main counterpart agency for the introduction of such fiduciary duties should be the Ministry of Finance. The Ministry of Finance would be the major counterpart for implementing the interventions considered in the areas of securities market regulation, insurance and pension reform as well as the implementation of accounting standards.

E. Workshop to Develop Consensus on Professional Ethics

The interviews conducted by the consultant team revealed a general lack of coordination between different ministries and other government institutions as well as a sense of isolation of business persons and the academic community. This is an issue of concern. Implementation of USAID interventions is likely to be jeopardized by a lack of information, and by the fragmented views and confusing or even contradictory efforts undertaken by different stakeholders, whether from the Palestinian Authority or private sector.

Therefore, the Team recommends that USAID undertake activities to interact with other key stakeholders in order to build consensus among those whose professional activities would be subject to the proposed professional ethics. To build this consensus and to ensure that the proposed professional ethics are workable and enforceable, a one-day workshop to present the required fiduciary standards to be embodied in the professional ethics should be held. This could be followed by seminars on each of the specific areas of USAID's planned interventions, but it is vital that this workshop be held early in the program. Holding the workshop early in the process ensures that the stakeholders - both regulators and potentially regulated financial practitioners and companies - understand what is going to be proposed.

The workshop would be convened by the Ministry of Finance with the support of USAID. The workshop would have the following objectives:

- Build consensus among the various stakeholders regarding the policy interventions recommended to mobilize equity capital in the Palestinian Territories
- Foster interaction among stakeholders with a view to facilitating understanding and future adoption of the policy interventions recommended
- Clarify the roles and responsibilities of the major stakeholders in the implementation of the policy interventions recommended.

Timing. The workshop should take place as soon as possible so as not to delay the drafting of proposed legislation.

Participants. The workshop should be limited to no more than 20 participants, if possible, in order to ensure active participation and open discussions. A preliminary list of participants would include the following:

- Two representatives from the Ministry of Finance (hosting the meeting);
- One representative from the Ministry of Trade and Economy;
- One representative from the Ministry of Labor;
- One representative from the Ministry of Planning ;
- One representative from the Ministry of Justice;
- Two representatives from the Palestinian Monetary Authority ;
- Two members of the Palestinian Legislative Council;
- Two representatives of the business community;
- Two representatives from the professional accounting communities in the West Bank and Gaza;
- Two representatives from labor unions;
- Three representatives from banking institutions - Arab Bank, Cairo-Amman Bank, and the Bank of Palestine;
- One representative from an insurance company.

Organization. Given that the workshop will present the conclusions and recommendations of the current assignment undertaken by Barents Group, it would be efficient if the consultants most germane to these issues - financial market laws (Ray Astin) and accounting standards (Maureen Berry) - could lead the workshop. They should arrive in Tel Aviv at least one or two days before the meeting in order to confer with USAID and to ensure that preparations are in order. While pre-workshop discussions between the consultants and USAID can take place in Tel Aviv, the workshop itself should take place in the Palestinian Territories, probably in Ramalah.

It is does not seem necessary that each consultant prepare an additional document for the workshop. However, someone, either from the consultant team or from the USAID Mission, should extract from the team's final report the major points to be incorporated in a separate document which will be provided to all participants.

Cost . The estimated costs for the workshop are detailed following the Executive Summary to this report.

F. Conclusion

Substantial benefits are to be gained from the incorporation of professional ethics, comprising fiduciary duties in each of the financial professions reviewed in this report (securities market, pension and insurance sectors, and accounting and auditing). Such professional ethics would provide an explicit standard against which to measure financial practitioners' performance. With such explicit standards, both investor confidence and practitioners' assurance of enforcement would be strengthened.

The effort to incorporate fiduciary duties in the Palestinian legal system's financial services regulations should be advanced on two fronts. First, it is necessary to place financial intermediaries under the obligation to observe, at all times, a set of fiduciary duties comprising professional ethics which takes into account the special nature of their operations. Second, fiduciary duties alone may not be sufficient to promote the type of environment sought for increasing investors' confidence. In order to maximize their impact, fiduciary duties should be complemented by other rules governing the organization, management and operation of financial intermediary institutions.

Any initiative that entails the enactment of laws may be negatively affected by the slow pace of the legislative process. Moreover, the lack of coordination between public institutions in the absence of a mechanism to establish a constructive and continuous dialogue between all stakeholders (public and private) may delay the adoption and implementation of policy interventions undertaken by USAID to mobilize equity capital to the Palestinian Territories.

As outlined in this section, specific elements of fiduciary laws can be incorporated into existing laws of the Palestinian Territories. By focusing on the professional ethics relevant to each financial service industry and by marshaling the support of both regulators and regulatees, each step will have the requisite support from all affected and effecting groups. The workshop recommended here is a first essential step toward successful legislative enactment of specific and appropriate fiduciary duties.

G. References for Incorporating Professional Ethics in Financial Services Laws of the Palestinian Territories

Draft Banking Law, English version dated February 1995 and Arabic version as of May 1997

Draft Supervision of Insurance Companies Law, May 1997

Israeli Banking Ordinance of 1941

Israeli Companies Ordinance of March 1994

Ordinance No. 8 of 1947 on Insurance

Palestinian Monetary Authority, Resolution No.1 of 199 ? «Provisions for Licensing Local Banks»

Palestinian Monetary Authority, Resolution No.2 of 199 ? «Provisions for Licensing Foreign Banks»

Palestinian Monetary Authority, Resolution No.3 of 199 ? «Licensing Fees»

Palestinian Monetary Authority, Resolution No.4 of 199 ? «Capital Requirements for Banks»

Palestinian Monetary Authority, Resolution No. 5 of 199 ? «Reserve Requirements for Banks»

The World Bank, Recommendations on a Securities Market Regulatory and Supervisory Structure for West Bank and Gaza, report prepared by Paula Perttunen, Financial Sector Development Department, January 14, 1997

The World Bank, West Bank Gaza Legal and Judicial Reform - Aide Memoire, June 20, 1996

The World Bank, Office Memorandum dated January 9, 1997 on West Bank and Gaza: Proposed Legal Development Project

The World Bank, West Bank and Gaza Private Sector Development - Framework for Private Sector Development and Support, May 12, 1995

Trustees Law of Gaza dated 1944

ANNEX A

List of Persons Interviewed by Organizational Affiliation

***interviewer(s) designated by initial of surname--**

Ray Astin(A), Maureen Berry (B), Lou Enoff (E),

Ana Maria Linares (L) or Mack Ott (O)

Palestinian Authority:

CIVIL SERVICE OF PALESTINIAN AUTHORITY

Mohammed Abu-Shaira, Director (E)

GENERAL CONTROL INSTITUTION

Jarar N. Kudwah, Auditor General (B)

Dr. Yousef M. Subuh, Advisor (B)

MINISTRY OF ECONOMY AND TRADE

Maher Masri, Minister (A,B,O)

MINISTRY OF FINANCE

Dr. Zuhdi Nashashibi, Minister (A,B,E,L,O)

Dr. Atef Alwaneh, Deputy Minister (B,E)

Mohammed H. El-Araj, Asst. Deputy Minister and Director General Insurance & Pension General Corporation (E)

Ghassan B. Qadan, Director General of Income Tax (B,O)

Naser A. Taboub, Director General of Value Added Tax and Excise (B,O)

Suleman Arif, Liaison Officer (A,B,E,L,O)

Dr. Hasan Falah Al-Haj Musa Al-Safareeni, Senior Consultant- Finance Law (B)

Samer Jitan, CPA, Office Director /Assistant to Dr. Atef Alawneh, (B,O)

Bayan Said Abu Shaban, Director General of Income Tax (B)

MINISTRY OF JUSTICE
Ibrahim Aldaghma, Deputy Minister

MINISTRY OF LABOR
Dr. Samir Ghosheh, Minister of Labor (E)

PALESTINIAN MONETARY AUTHORITY
Fouad Beseiso, Governor (A, B, L, O)
Anis Hajjeh , Banking Expert (A, B, L, O)
Asem Atary, Money Changers Division Manager (A, B, L, O)
Nahbih Mousa, Research Department Manager (A, B, L, O)

Donors:

INTERNATIONAL MONETARY FUND
Salam K. Fayad, IMF Resident Representative (B,E,O)

UNITED NATIONS
Khaled Abdel-Shafi, Director, UNDP (B)
Ugo Trojano, ILO Resident Representative (E)
Dr. Salem Ajluni, Head Economic & Social Monitoring Unit (O)
Husam Zomlot (A,B,O)

USAID MISSION, TEL AVIV
Chris Crowley, Mission Director (A,B,E,L,O)
Brad Wallach, Private Sector Project Officer (A,B,E,L,O)
Courtney Blair, Project Officer (A,B,E,L,O)
Peter Malnak, Project Development Officer (A,B,E,L,O)
Johny Zeidan, Private Sector Specialist (A,B,E,L,O)

U.S. EMBASSY
J.Feltman, Economist (A,B,E,O)
Paul Sutphin, Economist (A,B,E,O)

WORLD BANK
Judith Press, Senior Private Sector Development Specialist (E)
Mirza Qamar Ahmad, Senior Operations Officer, West Bank and Gaza, Middle East and North Africa Region (O)

<u>Accountants:</u>

ALLIED ACCOUNTANTS (ARTHUR ANDERSEN)
Waddah I. Barkawi CPA (B)
Raed W. Saqfelhait CPA (B)

MOHAMED A. SAADEH & CO. (ERNST & YOUNG INTERNATIONAL)
Hanna Quffa, CPA, Adjunct professor of accounting, Birzeit University (B,O)

SABA & CO. (DELOITTE TOUCHE TOHMATSU INTERNATIONAL)
Atallah R. Nasrallah CPA (B)

EL-YOUSEF & COMPANY (KPMG INTERNATIONAL)
Yacoub El-Yousef, CPA, Partner (B,O)

<u>Attorneys:</u>

Tawfik Abu-Ghazaleh, Advocate and Insurance Regulator (B,E,L)
Mazen Qupty, Managing Partner, Law Firm (E)
Ra'ed Abdul Hamid (L)
Sharhabeel Y. Al Zaeem, Senior Partner, Law Firm (E,L,O)

Other Private Sector:

AMERICAN LIFE INSURANCE COMPANY
Omraw Mousa Bitar, Unit Manager (E)

ARAB BANK
Joseph J. Nesnas, Manager, Institutional & Private Banking Department (B,E,O)

ARAB INSURANCE ESTABLISHMENT
Dr. Samir Abdullah, General Manager (O)
Ibrahim Abdelhadi, Managing Director (E)

BANK OF PALESTINE
Dr. Hani H. Shawa, Vice Chairman and Deputy General Manager (O)

BETHLEHEM UNIVERSITY
Sami El-Yousef, Assistant Vice President for Academic Affairs (B)
Jamil Koussa, Dean, Faculty of Business Administration (B)
Hanna N. Sahar, Manager, Business Development Center (B)

BIR ZEIT-PALESTINIAN PHARMACEUTICAL COMPANY
Talal Nasiruddin, President (E)

BIR ZEIT UNIVERSITY
Dr. Mohamed M. Nasr, Dean, College of Commerce and Economics (B)
Mirabo Shammas, CPA, Head, Department of Accountancy (B)
Adnan Abu Al-Humos, MBA, Instructor (B)
Ghassan Faramand, Deputy Director, University Law Center (E,L)

CAIRO AMMAN BANK

Ahmed Aweida, Manager, Marketing & Product Development (B,E,O)

Fayez Huseini, Director Financial Services Company, (B,E,O)

EL MASHREK INVESTMENTS

Yusef Habesh (E)

GAZA FEDERATION OF TRADE UNIONS

Rasem Bayyari, Chairman (E)

GAZA INSURANCE COMPANY

Dr. Mohammed Al Sabawi, Chairman and General Manager (E)

Osama Al Sabawi, Manager Reinsurance (E)

HEBREW UNIVERSITY

Dr. Efraim Kleiman, Professor of Economics (E)

ISRAELI-PALESTINE CENTER FOR RESEARCH AND INFORMATION (IPCRI)

Zakaria Al Qaq, International Director (A)

Gershon Baskin, Director (A)

JERUSALEM CIGARETTE COMPANY, LTD.

Dr. Mohamad A. Alami, Deputy Chairman (E)

MALHIS INDUSTRIES. & COMMERCIAL COMPANY

Yousef K. Malhis, Manager, Shoe Factory (E)

NATIONAL INSURANCE COMPANY

Aziz M. A. Jawad, General Manager (E)

PADICO

Dr. Amin Haddad, Chief Investment Officer (E)

PALESTINE GENERAL FEDERATION OF TRADE UNIONS

Abdul Raouf Mahdi, International. Relations Secretary (E)

PALESTINE INDUSTRIAL INVESTMENT CO. LTD. (A PADICO SUBSIDIARY)

Amar A. Aker, Financial Controller and adjunct professor of accountancy, Birzeit University (B)

PALESTINE INSTITUTE OF ACCOUNTANTS IN GAZA

Bayan Said Abu Shaban, President (B)

PALESTINIAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (West Bank)

Oudeh Jebreel CPA, President (B)

Jamal Tarifi CPA, Vice-President (B)

Rajai Kaisi CPA, Secretary (Hebron) (B)

Majed Kiswani CPA, Treasurer (B)

Muhamed Jawdi Al-Jabari CPA, Chair of Ethics Committee (Hebron) (B)

Hanna Quffa CPA, Chair, Accounting Standards Committee (B)

Ghassan Muhamed Sufar CPA, Member of Accounting Standards Committee (B)

PALESTINE/GAZA FEDERATION OF TRADE UNIONS

Shaher Saed, Chairman (E)

PALESTINIAN BUSINESS ASSOCIATION

Mahmoud El-Fara, Chairman and Chairman, El-Fara Group (E)

PALESTINIAN STOCK EXCHANGE

Safwan Bataina, General Manager (A,B,E,O)

Thaery Anro, Counsellor (A,O)

Allam Khalaf, Marketing Director (A,O)

PHARMACARE LTD.

Bassim S. Khoury, Assistant General Manager (E)

SILVANA SWEETS COMPANY, LTD.

Anton G. Mardirosian, Director-Manager (E)

Garbis Y. Mardirosian, Sales and Marketing Manager (E)

SINOKROT FOODS & BEIT EL-MAZ HOLDINGS

Mazen T. Sinorot, President (E)

ANNEX B

Appendixes to Section III

1. **Excerpts from Current Legislation Governing the Accounting and Auditing Functions in the West Bank and Gaza**
2. **Financial Reporting and Auditing in Jordan**
3. **The Core of Knowledge of the Professional Accountant**
4. **University Curricula For Accounting Majors**
5. **Comparison Of Auditors' Reports**

APPENDIX 1 Excerpts from Current Legislation Governing the Accounting and Auditing Functions in the West Bank and Gaza

(A) West Bank:

(1) Jordanian Company Law # 12, 1964.

CHAPTER EIGHT: AUDITORS

Section 168:

1. One or more licensed auditors shall be elected at a general meeting for a period of one year, which period may be renewed.
2. If an auditor has not been elected, or if an elected auditor declines to carry out this work, the Board of Directors must recommend to the controller three names from which he shall select one to fill the vacancy.

Section 169:

A person who is a partner of one of the members of the Board in the company's business may not be appointed as auditor of the company.

Section 170:

1. The auditors shall, jointly or severally, supervise the running of the company's affairs, audit its accounts and in particular investigate carefully whether its books are properly maintained, and whether the balance sheet and accounts of the company are so prepared as to reflect its true position.

2. The auditors shall have a right of access at all times to the company's records, books, papers and cash, and shall be entitled to request the Board of Directors to furnish them with all the information which may be necessary for the proper discharge of their duties, and the Board must place everything that may facilitate their task at their disposal.

Section 171:

1. The auditors must submit to the general meeting and to the controller a report in writing on the state of the company's affairs, its balance sheet, the accounts submitted by the Board of Directors, and on the proposals relating to the distribution of profits. The auditors shall recommend in their report the approval, with or without reservations, of the balance sheet, or its return to the Board of Directors.

2. The report must also discuss the following matters:

a. whether or not the balance sheet and profit and loss account submitted to the general meeting are in conformity with the laws, and with the books and financial state of the company.

b. the attitude of the managers and the members of the Board of Directors in furnishing the auditors with all the information they required in the course of the performance of their duties, and in facilitating the carrying out of their material investigations concerning all the financial matters which they wanted to study.

3. If the auditors discover any violation of the law or of the articles of association, they must inform the chairman of the Board of Directors and the controller of such violation in writing.

4. Serious violations must, however, be brought by the auditors to the attention of the shareholders in a general meeting.

5. The report of the auditors shall be submitted unanimously or by a majority, and any minority dissent must be submitted in a separate report.

6. If a report of the auditors is not submitted, or is not read out at a general meeting, any resolution adopted at such meeting approving the accounts and distribution of profits shall not be valid.

Section 172:

1. If the Chairman of the Board of Directors fails to convene a general meeting on the dates specified in the articles of association or under this law, then he shall be requested to do so by the auditors.

2. The auditors shall also have the right, jointly or severally, to request him to convene a general meeting at any time they deem it desirable.

Section 173:

1. The auditors shall be responsible for any mistakes they may commit in the course of their duties.

2. Any claim arising out of this responsibility shall be prescribed after the lapse of five years from the date of the general meeting at which the auditors' report was read out.

Section 174:

The auditors may not, under penalty of dismissal and compensation, pass any information which comes to their knowledge in the course of their duty, to any shareholder or any other party (except the controller).

CHAPTER NINE: COMPANY ACCOUNTS

Section 175:

1. The financial year of the company shall be the solar year, and the articles of association may specify the dates of its commencement and termination.

2. Every company shall maintain proper books of account.

Section 176:

1. An amount equivalent to ten per cent (10%) of the net profit must be set aside annually and placed to the credit of a compulsory reserve account.

2. These deductions may not be discontinued before the total amount accumulated in the aforesaid account shall have become equal to one-quarter of the company's capital. This proportion may be raised by a decision of the Board of Directors until the amount of the deductions becomes equal to the capital when they must be discontinued.

3. The compulsory reserve may not be distributed to the shareholders, but may be used to guarantee the minimum amount of profit prescribed by the concession agreement of a concessionary

company for those years during which the profits of such a company are not sufficient for the distribution of the guaranteed minimum profit.

4. Any amounts taken out of the reserve fund must be repaid into it if and when the profits of subsequent years permit.

5. No profits may be distributed to the shareholders before the deduction of the compulsory reserve; and dividends may only be paid to shareholders out of the profits.

6. The Board of Directors of a company in which the Government holds not less than 45% of the shares, may transfer its fixed assets to capital, after the proper valuation thereof by a committee appointed by the Board of Directors.

Section 177:

The members of the Board of Directors and the auditors shall be responsible for setting aside the specified amounts for compulsory and other reserve funds, and for depreciation, in accordance with the rates specified in the articles of association or in accordance with customary business practice.

Section 178:

1. The shareholders at a general meeting, may, on the recommendation of the Board of Directors, decide every year to deduct part of the net profits for a voluntary reserve fund, provided that the amount so deducted in any one year shall not exceed twenty per cent of the net profits for that year.

2. The total amounts so deducted for the voluntary reserve fund may not exceed half the amount of the company's capital, except in the case of insurance companies and banks.

3. The voluntary reserve fund may be used for any purpose which the Board of Directors may decide upon, and if it is not used, the Board of Directors may return it to the shareholders in the form of dividends.

Section 179:

A part of the profits, the amount of which shall depend upon the nature of the company's business, shall be deducted to meet the liabilities of the company under the labor laws in force. Such deductions shall be considered as part of the general expenses for the purposes of income tax.

Section 180:

The articles of association may provide for the setting up of a special fund to assist the workers of the company.

(2) Jordanian Law Governing the Practice of Auditing #10, 1961. (Unofficial translation of Arabic-language original)

Art. 2:

Auditing may only be practiced by those who are licensed as auditors and listed on the registry maintained by the Auditor General.

Art. 6: Art. 3:

In order to be licensed any one of the following qualifications must be met:

(a) membership in, and licensed by, the American or British Institute of Certified Public Accountants.

(b) holder of a Bachelor's degree in commerce, economics, or finance from a university or other institution of higher education plus experience in government, or in an accounting office in Palestine, of which not less than one year as a senior auditor or audit manager. A certificate of experience should be submitted to the certifying committee for approval.

(c) a high school diploma, or its equivalent, plus four years' experience as an audit senior or manager in a governmental or specialized audit office, or in the office of a public accountant authorized to practice in Palestine.

(d) an incomplete high school education plus full-time practice of auditing with a minimum of six years' experience as a senior auditor in a governmental or professional accounting office. (A "grandfather" provision.)

Art. 4:

Special requirements to practice as an auditor:

a. Jordanian (Palestinian) citizenship;

b. at least twenty-five years of age;

c. Not indicted for any criminal offense or ethics violation.

Art. 5:

1. Those practicing the profession in the Hashenite Kingdom (i.e. Jordan) for at least two years prior to the inception of this law are exempt from the requirements of article 3.

2. Foreigners may be allowed to practice as auditors if their country of origin grants reciprocity to those auditors licensed under this law.

A professional license may be granted to a company (i.e. a partnership or a corporation), a group of people, or those who have a home office in Jordan, all of whom meet the requirements of article 3.

Art. 7:

1. A licensing request should be submitted to the License Review Board consisting of the following members:

Deputy Minister of Finance (chair), Deputy Minister of Economy and Trade, Deputy Auditor General, Head of the Trade Division in the Ministry of Finance, and a practicing accountant.

2. The decisions of this committee, either unanimously or by a majority, are subject to approval by the Auditor General whose decision is final.

Arts. 15 and 16:

In the event that a complaint against a licensed auditor is lodged with the License Review Board, it is to be investigated by one of the Committee's members. If the complaint is found to be valid, the licensed auditor and his attorney are to be summoned to appear before the Committee which will then take appropriate action.

B. GAZA

Palestine Ordinance No. 18 of 1929 as amended through 1934.

Chapter 22: Companies.

Appointment and Remuneration of Auditors:

105.

(1) Every company shall, at its statutory meeting and thereafter at each annual general meeting, appoint an auditor or auditors to hold office until the next annual general meeting.

(2) If an appointment of auditors is not made at a statutory or annual general meeting, the registrar may, on the application of any member of the company, appoint an auditor of the company for the current year and fix the remuneration to be paid to him by the company for his services.

(3) A director or officer or any partner or employee of any director or officer of the company shall not be capable of being appointed auditor of the company.

(4) No person shall be capable of being appointed auditor of a company unless he is properly qualified by certificate from some university or other institution approved by the High Commissioner for the purpose, or by membership of some society of accountants or auditors, approved as aforesaid, or unless he has obtained from the Government of Palestine a certificate entitling him to practice in Palestine as an auditor.

(5) No corporation, but not including a firm, unless acting under an appointment made before the commencement of this Ordinance, shall be qualified for appointment as auditor of the company.

(6) No person, being a partner or in the employment of any office of a company, shall be qualified for appointment as auditor of a company.

(7) Any person or corporation which, in contravention of the provisions of this section, acts as auditor of a company is liable to a fine of one hundred pounds, and any appointment made in contravention of such provisions shall be void.

(8) A person, other than a retiring auditor, shall not be capable of being appointed auditor at an annual general meeting unless notice of an intention to nominate that person to the office of auditor has been given by a shareholder to the company not less than fourteen days before the annual general meeting, and the company shall send a copy of any such notice to the retiring auditor, and shall give notice thereof to the shareholders, either by advertisement or in any other mode allowed by the articles, not less than seven days before the annual general meeting:

Provided that if, after notice of the intention to nominate an auditor has been so given, an annual general meeting is called for a date fourteen days or less after the notice has been given, the notice, though not given within the time required by this provision, shall be deemed to have been properly given for the purposes thereof, and the notice to be sent or given by the company may, instead of being sent or given within the time required by this provision, be sent or given at the same time as the notice of the annual general meeting.

(9) Subject as hereinafter provided, the first auditors of the company may be appointed by the directors at any time before the first annual general meeting, and auditors so appointed shall hold officer until that meeting:

Provided that -

(a) the company may, at a general meeting of which notice has been served on the auditors in the same manner as on members of the company, remove any such auditors and appoint in their place any other persons being persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than seven days before the date of the meeting; and

(b) if the directors fail to exercise their powers under this subsection, the company in general meeting may appoint the first auditors, and thereupon the said powers of the directors shall cease.

(10) The directors may fill any casual vacancy in the office of auditor, but, while any such vacancy continues, the surviving or continuing auditor or auditors, if any, may act.

(11) The remuneration of the auditors of a company shall be fixed by the company in general meeting, except that the remuneration of any auditors appointed before the first annual general meeting, or to fill any casual vacancy, may be fixed by the directors.

(12) Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company and shall be entitled to require from the directors and officers of the company such information and explanation as may be necessary for the performance of the duties of the auditors and shall be entitled to attend any general meeting of the company at which any accounts which have been examined or reported on by them are to be laid before the company and to make any statement or explanation they desire with regard to such accounts.

(13) The provisions of sections 77 and 78 shall apply to and in the case of persons employed by a company as auditors, whether those persons are or are not officers of the company as they apply to and in the case of directors.

Accounts and Balance Sheet.

106.

(1) Every company shall cause to be kept proper books of account with respect to -

(a) all sums of money received and expended by the company and the matters in respect of which such receipt and expenditure takes place;

(b) all sales and purchases of goods by the company;

(c) the assets and liabilities of the company.

(2) The books of account shall be kept at the registered office of the company or at such other place as the directors think fit and shall always be open to inspection by the directors.

(3) The directors of every company shall, at some date not later than eighteen months after the incorporation of the company, and subsequently once at least in every calendar year, lay before the company in general meeting a profit and loss account or, in the case of a company not trading for profit, an income and expenditure account for the period, in the case of the first account, since the incorporation of the company, and, in any other case, since the preceding account, made up to a date not earlier than the date of the meeting by more then nine months, or, in the case of a company carrying on business or having interests outside Palestine, by more than twelve months;

Provided that the High Commissioner, if for any special reason he thinks fit so to do, may in the case of any company extend the period of eighteen months aforesaid, and in the case of any company and with respect to any year extend the periods of nine and twelve months aforesaid.

(4) The directors shall cause to be made out in every calendar year, and to be laid before the company, in general meeting, a balance sheet as at the date to which the profit and loss account or the income and expenditure account, as the case may be, is made up, and there shall be attached to every such balance sheet a report by the directors with respect to the state of the company's affairs, the amount, if any, which they recommend should be paid by way of dividend and the amount, if any, which they propose to carry to the reserve fund, general reserve or reserve account shown specifically on the balance sheet or to a reserve fund, general reserve or reserve account to be shown specifically on a subsequent balance sheet.

(5) If any person, being a director of a company, -

(a) fails to take all reasonable steps to secure compliance by the company with the requirements of subsection (1) or subsection (2), or has by his own willful act been the cause of any default by the company under either of the said subsections, or

(b) fails to take all reasonable steps to comply with the provisions of subsection (3) or subsection (4), he is guilt of an offense and is, in respect of each offense, liable to imprisonment for six months or a fine of two hundred pounds.

Provided that a person shall not be sentenced to imprisonment for an offense under this section unless, in the opinion of the court dealing with the case, the offense was committed willfully.

<u>107:</u>

(1) Every balance sheet of a company shall contain a summary of the authorized share capital and of the issued share capital of the company, its liabilities and its assets, together with such particulars as are necessary to disclose the general nature of the liabilities and the assets of the company and to distinguish between the amounts respectively of the fixed assets and of the floating assets, and state how the values of the fixed assets have been arrived at.

(2) There shall be stated under separate headings in the balance sheet, so far as they are not written off, -

(a) the preliminary expenses of the company; and

(b) any expenses incurred in connection with any issue of share capital or debentures; and

(c) if it is shown as a separate item in, or is otherwise ascertainable from, the books of the company, or from any contract for the sale or purchase of any property to be acquired by the company, or from any documents in the possession of the company relating to the stamp duty payable in respect of any such contract or the conveyance of any such property, the amount of the goodwill and of any patents and trade marks as so shown or ascertained.

(3) Where any liability of the company is secured, otherwise than by operation of law, on any assets of the company, the balance sheet shall include a statement that that liability is so secured, but it shall not be necessary to specify in the balance sheet the assets on which the liability is secured.

(4) Where any of the assets of a company consist of shares in, or amounts owing, whether on account of any loan or otherwise, from a subsidiary company or subsidiary companies, the aggregate amount of those assets, distinguishing shares and indebtedness, shall be set out in the balance sheet of the first-mentioned company separately from all its other assets, and, where a company is indebted, whether on account of any loan or otherwise, to a subsidiary company or subsidiary companies, the aggregate amount of that indebtedness shall be set out in the balance sheet of such company separately from all its other liabilities.

(5) Where a company (in this subsection referred to as “the holding company”) holds shares, either directly or through a nominee, in a subsidiary company or in two or more subsidiary companies, there shall be annexed to the balance sheet of the holding company a statement, signed by the persons by whom in pursuance of section 110 the balance sheet is signed, stating how the profits and losses of the subsidiary company, or, where there are two or more subsidiary companies, have, so far as they concern the holding company, been dealt with in, or for the purpose of, the accounts of the holding company, and in particular how, and to what extent -

(a) provision has been made for the losses of any subsidiary company either in the account of that company or of the holding company, or of both; and

(b) losses of any subsidiary company have been taken into account by the directors of the holding company in arriving at the profit and losses of that company as disclosed in its accounts; and, if in the case of a subsidiary company the report made by the auditors of the company under section 109 on the balance sheet of the company does not state without qualification that the auditors have obtained all the information and explanation they have required and that the balance sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanation given to them and as shown by the books of the company, the statement which is to be annexed as aforesaid to the balance sheet of the holding company shall contain particulars of the manner in which the report is qualified:

Provided that it shall not be necessary to specify in any such statement the actual amount of the profits or losses of any subsidiary company, or the actual amount of any part of any such profits or losses which has been dealt with in any particular manner.

(6) For the purpose of subsection (5) the profits or losses of a subsidiary company mean the profits or losses shown in any accounts of the subsidiary company made up to a date within the period to which the accounts of the holding company relate, or, if there are no such accounts of the subsidiary company available at the time when the accounts of the holding company are made up, the profits or losses shown in the last previous accounts of the subsidiary company which became available within that period.

(7) If for any reason the directors of the holding company are unable to obtain such information as is necessary for the preparation of the statement, referred to in subsection (5), the directors who sign the balance sheet shall so report in writing and their report shall be annexed to the balance sheet in lieu of the statement.

(8) Where the assets of a company consist in whole or in part of shares in another company, whether held directly or through a nominee and whether that other company is a company within the meaning of this Ordinance or not, and -

(a) the amount of the shares so held is at the time when the accounts of the holding company are made up more than fifty per cent of the issued share capital of that other company or such as to entitle the company to more than fifty per cent of the voting power in that other company, or

(b) the company has power, not being power vested in it by virtue only of the provisions of a debenture trust deed or by virtue of shares issued to it for the purpose in pursuance of such provisions, directly or indirectly to appoint the majority of the directors or persons occupying the position of director, by whatever name called in that other company, that other company shall be deemed to be a subsidiary company for the purposes of this section, and the expression "subsidiary company" in this section means a company in the case of which the conditions of this subsection are satisfied.

(9) Where a company, the ordinary business of which includes the lending of money, holds shares in another company as security only, no account shall, for the purpose of determining under subsection (8), whether that other company is a subsidiary company, be taken of the shares so held.

108:

(1) The accounts which, in pursuance of this Ordinance, are annually to be laid before every company in general meeting shall contain particulars showing -

(a) the amount of any loans which, during the period to which the accounts relate, have been made either by the company or by any other person under a guarantee from, or on a security provided by, the company to any director or officer of the company, including any such loans which were repaid during the said period;

(b) the amount of any loans made in manner aforesaid to any director or officer at any time before the period aforesaid and outstanding at the expiration thereof:

Provided that the foregoing provisions shall not apply -

(i) in the case of a company the ordinary business of which includes the lending of money, to a loan made by the company in the ordinary course of its business; or

(ii) to a loan made by the company to any employee of the company if the loan does not exceed two thousand pounds and is certified by the directors of the company to have been made in accordance with any practice adopted, or about to be adopted, by the company with respect to loans to its employees;

(c) the total of the amount paid to the directors as remuneration for their services, inclusive of all fees, percentages or other emoluments, paid to, or receivable by, them or by or from the company or by or from any subsidiary company:

Provided that this provision shall not apply in relation to a managing director of the company, and, in the case of any other director who holds any salaried employment or office in the company, there shall not be required to be included in the said total amount any sums paid to him except sums paid by way of directors' fees.

(2) If in the case of any such accounts as aforesaid the requirements of this section are not complied with, it shall be the duty of the auditors of the company by whom the accounts are examined to include in their report on the balance sheet of the company, so far as they are reasonably able to do so, a statement giving the required particulars.

(3) In this section the expression “emoluments” includes fees, percentages and other payments made, or consideration given directly or indirectly to a director as such and the money value of any allowances or perquisites belonging to his office.

109:

(1) The auditors shall make a report to the members on the accounts examined by them and on every balance sheet laid before the company in general meeting during their tenure of office and the report shall state -

(a) whether or not they have obtained all the information and explanations they have required; and

(b) whether in their opinion the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them and as shown by the books of the company.

110:

(1) The balance sheet shall be signed on behalf of the board by two of the directors of the company and the auditors' report shall be attached to the balance sheet.

(2) A copy of every balance sheet, including every document required by law to be annexed thereto, which is to be laid before the company in general meeting, together with a copy of the auditors' report, shall, not less than seven days before the date of the meeting, be sent to all persons entitled to receive notices of general meetings of the company, and if the company makes default in complying with the foregoing requirement, the company and every director, manager, secretary or other officer of the company who knowingly and willfully authorizes or permits the default is liable to a fine of twenty pounds.

(3) If any copy of a balance sheet which has not been signed as required by this section is issued, circulated or published, or if any copy of a balance sheet is issued, circulated or published without having a copy of the auditors' report attached thereto, the company and every director, manager,

secretary or other officer of the company who is knowingly a party to the default is liable to a fine of fifty pounds.

111:

(1) Any member of a company, whether he is or is not entitled to have sent to him copies of the company's balance sheets, and any holder of debentures of a company, shall be entitled to be furnished gratis on demand with a copy of the last balance sheet of the company, including every document required by law to be annexed thereto, together with a copy of the report of the company's auditors on the balance sheet.

(2) If, where any person makes a demand for a document with which he is by virtue of this section entitled to be furnished, the company fails to comply with the demand within seven days after the making thereof, the company and every director, manager, secretary and other officer of the company who is knowingly a party to the default, is liable to a fine of five pounds for every day during which the default continues, unless it is proved that that person has already made a demand for, and been furnished with, a copy of the document.

APPENDIX 2: Financial Reporting and Auditing in Jordan

Statutory Requirements

In accordance with the Jordanian Commercial Law (Trade Law No. 12 of 1966), all companies are required to keep a general journal, inventory records, and a correspondence register. All accounting records must be kept within Jordan, either in Arabic or English.

Sources of Accounting Principles

Formal accounting standards have not yet been issued in Jordan. However, in 1989 the Jordanian Association of Certified Public Accountants (JACPA) Board of Directors resolved to adopt standards issued by the International Accounting Standards Committee (IASC) effective 1 January 1990. Accordingly, entities are encouraged to comply with International Accounting Standards.

Financial Statements

In accordance with Provisional Companies Law No. 1 of 1989, all shareholding companies, branches of foreign companies, limited liability companies, and limited partnership in shares companies are required to file audited financial statements annually with the Controller of Companies. In addition, the Income Tax Department requires copies of audited financial statements to be filed with the required self-assessment form.

Disclosure Requirements

No set form or content exists for financial statements, except in the case of banks and insurance companies, whose financial statements must be prepared in accordance with the format set out by the Central Bank of Jordan and the Insurance Controller respectively.

If an audit is required, the audit report accompanying the financial statements states that the company has complied with the Companies Law No.1 of 1989.

Reporting and Filing Requirements

Audited financial statements of public shareholding companies, limited liability companies, and operating foreign branches must be submitted to the Ministry of Industry and Trade and the Income Tax Department. Half-yearly unaudited financial statements must be submitted to the Amman Stock Exchange and the Central Bank of Jordan.

Public shareholding companies and operating foreign branches must publish their financial statements in two local newspapers.

Licensed banks are subject to further reporting requirements.

Regional offices are not required to produce or file financial statements.

Audit Requirements

All shareholding companies, branches of foreign companies, limited liability companies, and limited partnership in shares are required by law to produce annual audited financial statements.

Only auditors licensed by the Accounting Professional Council are authorized to sign audit reports. These auditors are classified into three categories, according to their relative educational qualifications. A category A auditor has a university degree in accounting and a minimum of three years' experience, of which one year is in public accounting. A Category B auditor has a university degree in business or law with a minimum of five years' experience, of which one year is in public accounting. Category C auditors are all other auditors. Banks and public shareholding companies may be audited only by class A auditors.

Accounting Profession

The accounting profession in Jordan is regulated and controlled by the Accounting Professional Council and the Jordanian Association of Certified Public Accountants. In order to become a licensed auditor, the applicant must pass an examination. Exceptions are made for Jordanians holding major recognized accounting qualifications, usually from the United Kingdom or the United States, who may be granted membership without sitting for the examination at the discretion of the Council.

The Jordanian Association of CPAs was created in 1987 and is responsible for issuing accounting standards and ethical standards. The Association has not yet issued auditing standards.

SOURCE: Whinney Murray & Co. *Doing Business in Jordan*. Ernst & Young. Amman: 1995, pp. 1 & 35-36.

APPENDIX 3: The Core of Knowledge of the Professional Accountant

Core Subjects

Financial Accounting

The scope of financial accounting.

The function of accounting is to provide information to present and potential investors, owners, managers, creditors, regulators, tax authorities, employees, and others. Government and their agencies also use financial accounting in reporting to the public. The information provided is primarily financial in nature and is intended to be useful in making decisions about economic entities such as those in industry, commerce, government and other not-for-profit areas. Financial accounting is concerned with both the measurement and the communication of financial information.

<u>Summary of relevant topics</u>*:*

Financial accounting principles; financial reporting; reporting under regulatory acts; and data accumulation and analysis;

Management Accounting

Nature and objectives of management accounting:

The focus of management accounting is on information required for internal rather than external uses. However, some of the concepts and procedures pertaining to management accounting are common to those for financial accounting. These uses include control of operations, monitoring of cash flow, and evaluating alternative decisions involving such things as pricing, production methods, capital investments and sources of capital. An effective system of management accounting enables an organization to handle day-to-day operations, identify problems and deal with them, and to make short and long range plans and evaluate performance.

<u>Summary of relevant topics:</u>

Cost and revenue classification and analysis; accounting for costs; budgeting and standard costs; decision models; and performance measurement.

Information Technology (IT)

General:

Students should acquire a basic knowledge of computer components and operations, computer software and its application, and computer development and management. They are not expected to achieve the same level of knowledge as an IT specialist. However, it is contemplated that they would expand upon their basic knowledge during their professional careers to cover matters such as accounting system design, internal control in a computer environment and EDP auditing.

Summary of relevant topics*:*

Objective and scope of systems; basic elements and concepts of information systems; and EDP systems.

Auditing

Auditing Objectives:

While the principal objective of auditing is to make financial and other information more credible, it may have additional objectives depending on the nature of the engagement. These include the determination of compliance with the requirements of government and other regulatory agencies, special investigations and, for internal purposes, the evaluation of the efficiency of operations and of adherence to management policies.

Summary of relevant topics:

Auditing concepts; evidence; practices and procedures; and rights, duties, and liabilities of auditors.

Taxation

Objectives of taxation:

Taxes are levied upon individuals and enterprises by central and local governments and are administered by government agencies primarily to raise revenue to support various government services and activities. They are also used as incentives and disincentives to accomplish certain economic, social, and political objectives consistent with government philosophies. Taxation has a substantial impact on decision making in economic entities both in terms of their financial planning and in the measurement of their income.

Summary of relevant topics*:*

Types and nature of taxes; and the professional accountant's role in taxation.

Business Finance

Relationship of finance to accounting:

Because professional accountants practice in a structured financial environment, business finance is an important element of the core of knowledge. Business finance is broadly concerned with the generation, allocation and control of capital. ,Accounting plays a dual role in this process. It simultaneously provides information for financial decisions and reflects the resulting financial effects of those decisions.

Summary of relevant topics:

Financial environment; financial dimensions of organizations; and financial decisions.

Supportive Subjects

General:

The knowledge of supportive subjects is as essential as that of core subjects if professional accountants are to discharge their functions effectively. This is so because supportive subjects equip them with knowledge about the relevant environment. Furthermore, core subjects derive some of their concepts from the supportive subjects. For example, the concepts of income measurement and break-even analysis in economics are also used in accounting and the subject of information technology derives some of its concepts from mathematics and behavioral sciences. Communication, motivation and leadership will better equip accountants to be more effective as professionals during their careers.

The vast scope of the supportive subjects makes it impracticable to impart a thorough knowledge of each area. The level of knowledge required in supportive subjects should be sufficient to provide the necessary understanding of those aspects which are relevant to the work of professional accountants.

Economics

The study of economics enables a better appreciation of accounting principles and concepts because accounting systems measure economic information and draw heavily on the concepts of economics. The study of the economic environment of a country helps students to view the accounting finance function from a wider perspective.

Summary of relevant topics:

Nature of economics; economic systems and markets; national income and expenditure; monetary and fiscal policies; international trade; demand and supply; price and output determination; economic models; forecasting; and decisions involving time and uncertainty.

Law

Law prescribes those rights and obligations that are enforceable. Law emanates from various sources, such as statutes, customs and legal precedents. Law may be broadly classified as constitutional law, administrative (or regulatory) law, criminal law, fiscal law and mercantile or commercial law. The professional accountant primarily needs knowledge of those mercantile, fiscal, social, labor and regulatory laws that are concerned with, and apply to, trade, commerce, industry, succession, money and property.

Summary of relevant topics:

Laws of contracts and sale of goods; laws of associations; law of companies; and laws of insolvency.

Mathematics and Statistics

Mathematics and statistics provide a system of logic which is helpful in analyzing many theoretical and practical problems. Many concepts and techniques of mathematics are directly relevant to other subjects included in the core of knowledge. The professional accountant needs to know how and when to use different formulas and models and how to interpret the results.

Summary of relevant topics:

Mathematics: including algebra, linear algebra, and calculus; statistics: including probability theory; sampling and tests of significance; and forecasting techniques.

Behavioral Sciences

Behavioral science is the scientific study of human behavior. Many subjects included in the core of knowledge have an intimate link with behavioral sciences. For example, management accountants interact with other managers at all levels of an organization by virtue of their advisory and control functions. Similarly, the concepts of behavioral science are relevant to other subjects, such as information technology and auditing.

Summary of relevant topics:

Concepts of psychology and sociology; introduction to research methods; learning and performance; attitudes; motivation; stress; and groups and leadership.

Management

Management is the process that integrates the efforts of a group of people toward effective achievement of an organizational goal. It involves the functions of planning, organizing, staffing, direction, and control of the resources of the organization, particularly its people. Knowledge of the management process is essential for professional accountants as it enables them to provide the relevant information to management for effectively discharging its functions and also to achieve their own organizational goals.

Summary of relevant topics:

Planning; decision making; organizing; staffing; directing; control; and organization and environment.

SOURCE: International Federation of Accountants, 1996. *IFAC Handbook 1996 Technical Pronouncements*. New York, pp. 555-566 (abridged.)

APPENDIX 4: University Curricula For Accounting Majors

A. Bethlehem University

Department of Accounting

The department of accounting is headed by the dean of the business school, Jamil Koussa, and comprises three full time, and one part-time faculty: none with a terminal degree. It offers an undergraduate program in accounting with a minor in business administration.

Requirements for Accounting Majors

Students are accepted as accounting majors after the third semester, provided they have earned 40 credit hours and meet the following conditions:

1. Minimum overall cumulative grade point average (GPA) of 1.50 (on a 4-point scale);
2. Minimum major cumulative GPA of 2.00;
3. Completion of at least one course in the major field;
4. Completion of ENGL 103 and ENGL 104;
5. A minimum GPA of 2.00 in BUSM 101, ACCT 201, ECON 234, BUSA 227.

Program Requirements

The program requirements are divided into five categories: Major, Minor, Faculty, University, and Elective courses. The Faculty, University, and Elective requirements are common to all majors and minors in the Faculty of Business, while the Major and Minor requirements differ from one program to another. Following is a summary of the requirements:

<u>University Requirements</u> (31 credit hours)

Arabic 101 and 102; English 103, 104, and 201; Cultural Sciences 201, 202, 301, and 302; Physical Education 101, and CMSR 101.

Faculty (i.e. College) Requirements (14 credit hours)

ECON 234: Fundamental Statistics for Business; BUSA 227: Introduction to Data Processing; BUSA 288: Practicum (6 weeks work experience internship for two credit hours); BUSA 350: Business Policy; ENGL 231: English Business Communications.

Electives (15 credit hours)

Elective courses can be taken from any faculty (i.e. college) in the University. However, students who graduated from high school in the liberal arts (as opposed to the sciences) stream are encouraged to use 6 of the 15 credits in Science courses.

Accounting Major Requirements (48 credit hours)

BUSM 101 and 102: Business Mathematics I and II

Econ 101 & 102: Micro Economics and Macro Economics;

ACCT 201, 202: Principles of Accounting I and II,

ACCT 301, 302: Intermediate Accounting I and II;

ACCT 303: Cost Accounting;

ACCT 304: Principles of Auditing;

ACCT 305: Managerial Accounting;

ACCT 306: Taxation;

ACCT 307: Accounting Information Systems;

ACCT 308: Advanced Financial Accounting; and

ACCT 309: Government and Fund Accounting.

BUSA 389: Senior Seminar: This course is designed to provide senior business students with an opportunity to conduct a Seminar integrating two or three topics in the student's area of concentration. Faculty members assist as coordinators or resource consultants. The written research paper must be presented to the Faculty of Business. Required of, and restricted to, all business and accounting majors in the last term of their senior year.

Business Administration Minor Requirements (20 credit hours)

BUSA 265: Quantitative Business Analysis;

BUSA 211: Principles of Management;
BUSA 331: Principles of Marketing;
BUSA 312: Financial Management;
BUSA 333: Advanced Financial Management; and
BUSA 232: Commercial Law.

B. Birzeit University

A revised curriculum with uniform core of knowledge will take effect from the spring semester, 1998. At present, Finance courses are taught in the Business Administration department. These will be transferred to a newly-created Finance Department to be added to the existing three departments (Accounting, Business Administration, and Economics) in the School of Business in the Fall 1997 or Spring 1998 semesters.

The Accounting faculty all have master's degree, two are CPAs who obtained their licenses in the United States, none have a terminal degree. The Head of Department is Mirabo Shammas, CPA who is also employed at the KPMG affiliate in Ramallah.

Faculty composition:

Full time:		4
On sabbatical leave:		1
Leave without pay:		1
Part-time:		4
Total:	10	

A total of 120-128 credit hours are required for graduation

University Requirements (currently 30 hours; revised: 20 hours)
Arabic language (revised to 6 hours from 3 hours);
English language (from one to three courses depending on performance on entrance exam);
Physical education (one credit hour each);

Cultural studies: e.g. history of philosophies, ancient civilizations, historical events etc. (currently 10 hours; revised: 6 hours);
Library usage (currently 1 hour; revised: discontinued);

College Requirements (33 - 36 hours)
First principles course required from each of the three (revised: four) College departments; (9-12 hours)
BUS 229: Basic course in computer software; (3 hours)
Research skills (organizing, preparing, and writing a research paper); (3 hours)
Maths 135 (basic maths for high school graduates in liberal arts); (3 hours)
Maths 235 (set theory, calculus, linear equations); Maths 236 (Statistics); (6 hours)
General sciences (131 and 132) (6 hours)
Technical writing (to be added: 3 hours)

Accounting Majors (currently 36 hours; revised: 42 hours)
Prequalifications:
Students must pass the accounting principles courses (231 and 232) with at least a 70 percent grade, plus Business Mathematics (235) before they can apply for the accounting major. The Accounting department screens these requests so as to identify the best candidates (in the fall semester of 1996, 37 applications out of 45 were approved) so admission is not automatic. Experience has shown that those applicants who entered the science stream during the last two years of high school have better chances for admission to the accounting program.

Core courses (30 hours after the principles courses)
Cost accounting (331); Intermediate-I (335); Intermediate-II (336); Advanced (432); Managerial (433); Seminar in Accounting (437);
Revised curriculum will add 3 required courses previously electives: Tax Accounting (332); Auditing-I (339); Accounting Information Systems (434);

Business Administration courses (principles plus 10 additional hours)
Introduction to Business (130); Introduction to Finance and Banking (130);Principles of Management (230); Principles of Finance (BUS 234); Principles of Marketing (BUS 237); Business Law (BUS 340);

Economics: (principles plus 6 hours)
Principles (required): Macro and Micro Economics (ECON 130 and 230); plus 6 additional credit hours (any 2 of 4 courses): Advanced Micro-Economics (331); Advanced Macro-economics (332); International Trade (336); Money and Banking (338).

Finance: (6 additional hours under revised curriculum)
(Note: Currently, finance courses are taught in the business administration department.) Advanced Financial Management (FIN 330); Financial Analysis (FIN 331).

Electives (currently 3; revised: 7)
Any courses from the total course listings, other than those required.

APPENDIX 5: Comparison Of Auditors' Reports

A. Auditors' Report Presented in Accordance with International Auditing Standards.

AUDITORS' REPORT

To the Shareholders of Arab Bank Plc
Amman - Jordan

We have audited the accompanying balance sheet of Arab Bank Plc (a Jordanian Public Shareholding Limited Company) as of 31 December 1996 and 1995 and the related statements of income and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit. We have obtained the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit.

We conducted our audit in accordance with the International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

The Bank maintains proper accounting records which are in agreement with the accompanying financial statements and with the financial information included in the Board of Directors' report.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of Arab Bank Plc as of 31 December 1996 and 1995 and the results of its operations and its cash flows for the years then ended in accordance with International Accounting Standards, and we recommend that the General Assembly approve these financial statements.

XXX & Co.
Amman - Jordan
30 January 1997

SOURCE: Arab Bank Group, Annual Report 1996, p. 45.

B. Auditor's Report Not Presented in Accordance With International Auditing Standards

AUDITORS' REPORT
To the shareholders of The Bank of Palestine

We have examined the balance sheet of the Bank of Palestine Ltd. as at 31st December 1996 and the Statement of Profit and Loss as well as the changes in the appropriated capital and the changes in Cash Account for the year ending at that date in respect of the aforesaid Balance Sheet. Our examination thereof was conducted in accordance with the recognized auditing standards. Accordingly, we have applied such auditing procedures as we deemed appropriate in the circumstances.

The above-mentioned statements are based on the modified historical cost convention taking into consideration the variations affecting the purchasing power of the Sheqel in terms of the Cost of Living Allowance (CLA) for the consumer.

To the best of our knowledge and in conformity with the adopted accounting principles during the work of the Bank on 31st December 1996, the above financial statements fairly focus on the status of the Bank's capital and the cash account for the year then ended.

XXX YYY
Chartered Accountant

Nazareth, 8 March 1997

SOURCE: Bank of Palestine Ltd Annual Report for 1996, p. 10.

C. Departures from International Auditing Standards in Section B:

The auditor's report on the 1996 financial statements of the Bank of Palestine Ltd. departs in many respects from international auditing standards. Details follow.

1. Opening or Introductory paragraph:

(a) does not identify the financial statements audited. (Refer to explanation.)

(b) does not contain a statement of the responsibility of the entity's management and the responsibility of the auditor;

(c) combines the scope paragraph, which describes the nature of an audit, with the introductory paragraph. The last two sentences of the first paragraph should constitute the second, that is scope, paragraph.

Explanation:

Comparative financial statements for 1995 are presented together with those for 1996 but are not referred to in the auditor's report. So, it is not clear as to what responsibility, if any, the auditor is assuming for the 1995 financial statements. (When comparative financial statements are presented, the auditor should issue a report in which the comparatives are specifically identified because the auditor's opinion is expressed individually on the financial statements of each period presented.)

2. Scope section (last two sentences of opening paragraph) does not adequately describe the work the auditor performed.

Explanation:

The report states that such auditing procedures were applied as were deemed appropriate in the circumstances. The nature of these procedures should have been identified as per the wording used in the scope (second) paragraph of the auditors' report in section A above.

3. Failure to explain or elaborate on a departure from the historical cost convention. The auditor has modified the report by adding an emphasis of matter paragraph. This (the basis of accounting which takes into account changes in the consumer's "cost of living allowance". No other reference to this matter appears elsewhere in the financial statements, such as the authoritative support for its use, how it was calculated, and the amount(s) of the adjustment(s) made from historical cost .

4. Failure to comply with presentation of a cash flow statement as required by International Accounting Standard 7.

5. Failure to express an opinion on the financial statements.

The auditor's report should clearly state the auditor's opinion as to whether the financial statements give a true and fair view (or are presented fairly, in all material respects,) in accordance with the financial reporting framework and, where appropriate, whether the financial statements comply with statutory requirements.

In this report, the auditor does not express an opinion on the financial statements identified in the first paragraph as having been examined. Instead, it is stated that "the above financial statements fairly focus on the status of the Bank's capital and the cash account for the year then ended". This statement is silent as to the Statement of Profit and Loss because the status of the Bank's capital, and the cash account, appear only on the balance sheet which is presented as of a certain date and not for a period of time.